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A Report to the Senate and House Committees on the Budget—Part I

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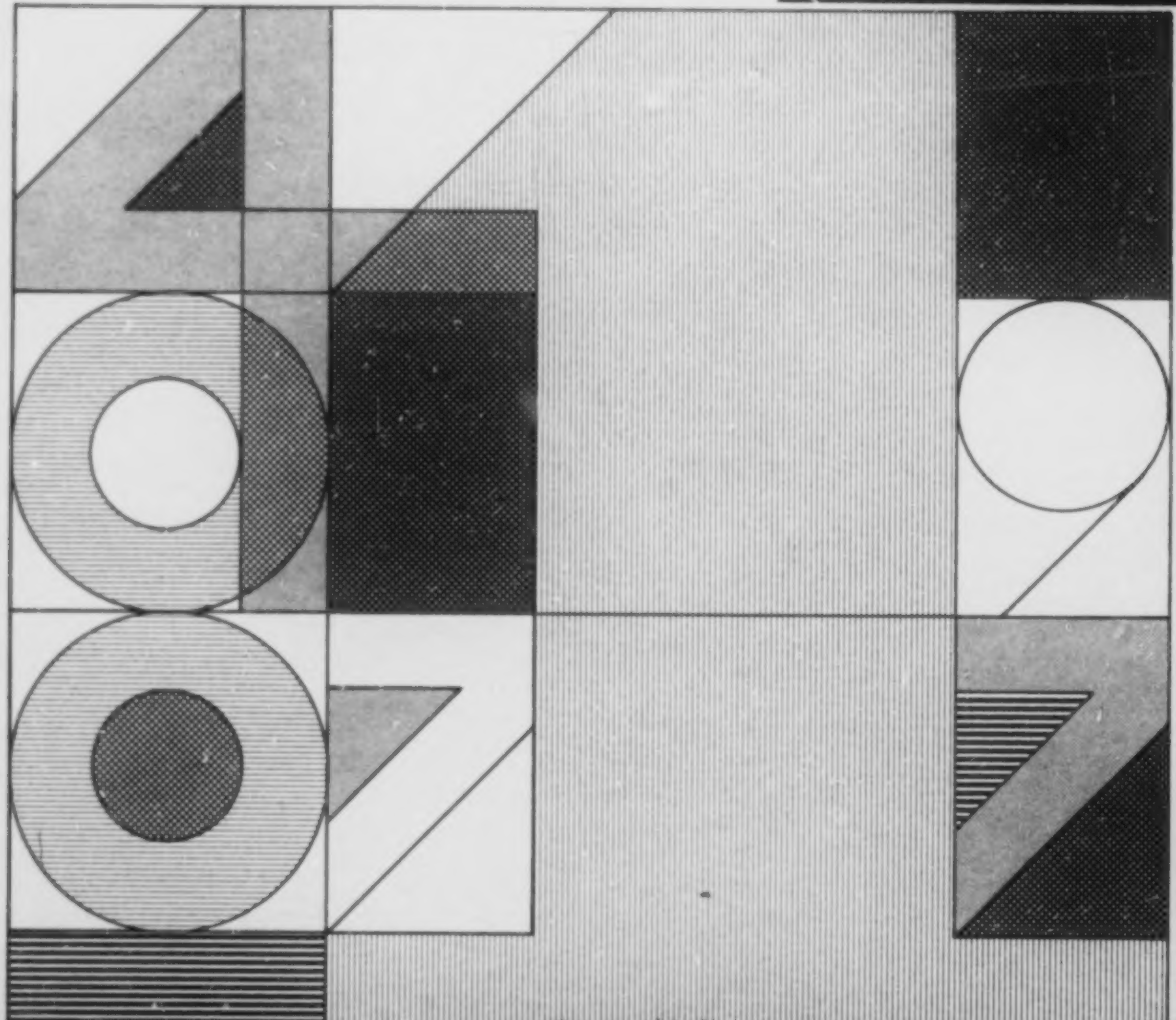

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1986 ANNUAL REPORT

THE ECONOMIC AND BUDGET OUTLOOK:
FISCAL YEARS 1987-1991

The Congress of the United States
Congressional Budget Office

NOTES

Unless otherwise indicated, all years referred to in this report are calendar years.

Unemployment rates throughout the report are calculated on the basis of the civilian labor force.

Details in the text and tables of this report may not add to totals because of rounding.

The Balanced Budget and Emergency Deficit Control Act of 1985 is also referred to in this volume more briefly as the Balanced Budget Act.

PREFACE

The Congressional Budget Office (CBO) is required by section 202(f) of the Congressional Budget Act of 1974 to submit an annual report on budgetary options to the House and Senate Committees on the Budget. This year, the report is in two parts. This volume, Part I, presents projections of federal revenues and spending that would occur if current laws and policies continued unchanged for the next five years. It also examines the state of the economy and the economic outlook with these budget policies. Part II, *Reducing the Deficit: Spending and Revenue Options*, presents for Congressional consideration a number of broad strategies to reduce projected budget deficits and various specific options for cutting outlays and increasing revenues. In accordance with CBO's mandate to provide objective and impartial analysis, these reports contain no recommendations.

The analysis of the economic outlook presented in Chapter I was prepared by the Fiscal Analysis Division under the direction of William J. Beeman and Jacob S. Dreyer, with the assistance of Robert A. Dennis, Victoria S. Farrell, Douglas R. Hamilton, George R. Iden, Stephen A. Parker, John F. Peterson, Martin A. Regalia, Frederick C. Ribe, Frank S. Russek, Jr., Matthew A. Salomon, John R. Sturrock, Stephan S. Thurman, Lucia S. Foster, Stacy A. Miller, Jeffrey Steger, and Bragi Valgeirsson.

The baseline outlay projections were prepared by the staff of the Budget Analysis Division under the supervision of James L. Blum and C.G. Nuckols. The revenue estimates were prepared by the staff of the Tax Analysis Division under the direction of Rosemary D. Marcuss and Kathleen M. O'Connell with the assistance of Valerie Amerkhail, Neil Fisher, Robert Lucke, Preston Niblack, Linda Radey, and Jan Sundgren. Paul N. Van de Water and Rosemary D. Marcuss were the principal authors of Chapter II and Appendix A. The other appendixes were prepared by David A. Bashore, Paul T. Christy, Andrew F. Haughwout, Richard F. Krop, and Kathy A. Ruffing, who also prepared many of the tables and boxes in Chapter II. James L. Blum wrote Chapter III.

Paul L. Houts supervised the editing and production of the report, assisted by Nancy H. Brooks. Major portions were edited by Francis S. Pierce, Patricia H. Johnston, and Sherry Snyder. Debra M. Blagburn coordinated the preparation of the report. The authors owe special thanks to Dorothy J. Kornegay, Thelma L. Jones, Paula Gatens, Earnestine Miles, and L. Rae Roy, who typed the many drafts. Additional assistance was provided by Kathryn Quattrone.

Rudolph G. Penner
Director

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SUMMARY

The outlook for reducing budget deficits has improved dramatically since last summer, and financial markets have responded with a sharp rally. Although overall economic activity has not yet reacted to these improved financial conditions, the Congressional Budget Office (CBO) expects economic growth to pick up this year.

In 1985, the economy grew at a comparatively low rate of 2.3 percent, well below the substantial gains in the first two calendar years of the current expansion. Growth in productivity came to a halt as employment continued to grow rapidly. The unemployment rate edged down during 1985 and, despite three full years of recovery, the inflation rate remained almost unchanged from the moderate rates attained during the last recession.

Most forecasters, including CBO, anticipate that growth in real gross national product (GNP) will be somewhat faster this year--at about 3½ percent--than it was in 1985. The tremendous rally in financial markets during the second half of 1985 and the sharp decline in the dollar have enhanced the prospects for a pickup in economic activity in 1986. The rise in stock prices and the decline in interest rates will encourage consumer spending and business capital spending, while the decline in the dollar should halt the deterioration in the trade sector. If lower oil prices are sustained, the sharp drop in prices early this year will contribute to growth in economic activity and restrain inflation.

The improvement in financial conditions and the decline in the dollar last year were, at least partially, the result of the dramatic change in the outlook for reducing future budget deficits. The implementation of the Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177), together with earlier Congressional action, will reverse the recent trend of rising budget deficits. Although a federal district court recently ruled that certain aspects of the Balanced Budget Act are unconstitutional, the deficit targets established by the act still remain in effect. These targets would lower projected deficits from about $208 billion in the current fiscal year to $144 billion in fiscal year 1987, with annual reductions of $36 billion thereafter. The decline in the structural deficit from fiscal year 1986 to 1987 would be about 1.5 percent of potential GNP, the third largest such reduction in fiscal stimulus since the mid-1950s. By itself, such an abrupt shift in fiscal posture could temporarily slow the economic expansion in 1987. But several other factors--including the decline in the dollar, lower interest rates, and the fall in oil prices--are expected to counteract the contractionary effects of the budget shift.

CBO's new baseline budget estimates show much smaller deficits in the 1987-1990 period than the baseline projection of last summer (see Summary Table 1). While the policies of last year's budget resolution were not fully carried out, Congressional action to date has significantly lowered projected defense and nondefense spending. The projected decline in budget

SUMMARY TABLE 1. BASELINE BUDGET PROJECTIONS, DEFICIT TARGETS, AND UNDERLYING ECONOMIC ASSUMPTIONS

	Actual 1985	1986	1987	1988	1989	1990	1991
Budget Projections (By fiscal year, in billions of dollars)							
Baseline Estimates							
Revenues	734	778	844	921	991	1,068	1,144
Outlays	946	986	1,025	1,086	1,135	1,188	1,248
Deficit	212	208	181	165	144	120	104
Deficit Targets	N.A.	a/	144	108	72	36	0
Baseline Less Targets	N.A.	a/	37	57	72	84	104
Economic Assumptions (By calendar year)							
Nominal GNP, percent change	5.8	6.9	7.3	7.6	7.8	7.8	7.5
Real GNP, percent change	2.3	3.2	3.1	3.3	3.5	3.5	3.2
CPI-W, percent change	3.5	3.4	4.2	4.4	4.4	4.3	4.3
Civilian Unemployment Rate	7.2	6.7	6.7	6.5	6.3	6.1	6.0
Three-Month Treasury Bill Rate	7.5	6.8	6.7	6.4	6.1	5.7	5.4

SOURCE: Congressional Budget Office

NOTE: N.A. = not applicable.

a. The Balanced Budget Act set a target of $171.9 billion in fiscal year 1986, but limited the sequestration to $11.7 billion. CBO's fiscal 1986 baseline deficit estimate includes the $11.7 billion sequestration, and therefore the $208.3 billion deficit for that year fulfills the act's requirement.

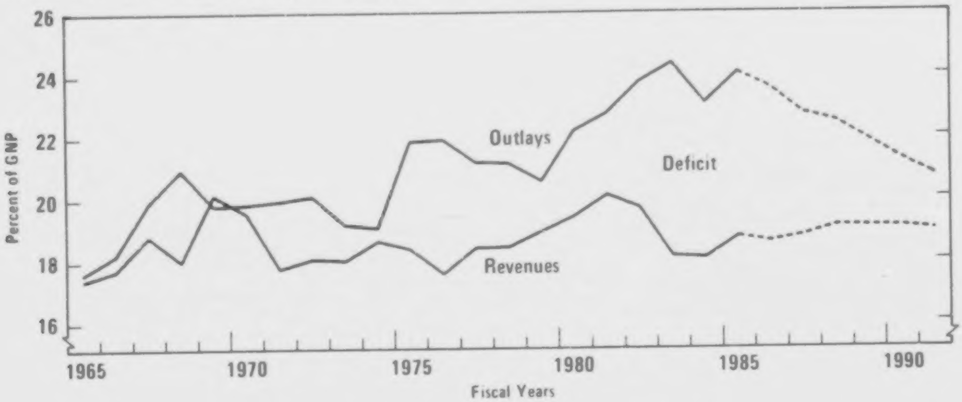
deficits under the policy assumptions of the baseline occurs because revenues are projected to grow in response to both inflation and growth in real incomes, while outlays are projected to grow only slightly faster than the rate of inflation (see Summary Figure 1). The baseline assumes no real growth in defense and nondefense appropriations above a base already cut by the 1986 sequestration called for in the Balanced Budget Act. The additional action needed to comply with the deficit targets amounts to about $37 billion in fiscal year 1987, or $354 billion over the 1987-1991 period.

The sharp decline in long-term interest rates in 1985 seemed to reflect a market expectation of less Treasury borrowing in future years. Sectors of the economy that are interest-sensitive, such as residential construction, already show signs of increased strength. But the major benefit of reduced budget deficits will come, it is generally agreed, in their long-run effects on living standards. Other things being equal, lower deficits should reduce real interest rates and foreign capital inflows, thereby encouraging increased domestic capital formation and reduced foreign indebtedness.

THE ECONOMIC OUTLOOK

The slowing of economic growth in 1985 was largely the result of a reduction in inventory investment. Growth in real final sales was down only

Summary Figure 1.
Baseline Revenues and Outlays



SOURCES: Congressional Budget Office; Office of Management and Budget; U.S. Department of Commerce, Bureau of Economic Analysis.

slightly from 4.5 percent in 1984 to 4.0 percent in 1985, as weaker household and business spending was partially offset by strengthened government defense purchases and slower deterioration of the trade sector.

At year-end, most indicators began to reflect improving economic conditions. A major exception was net exports, which in December showed sharp further deterioration. But housing starts, retail sales, durable goods orders, employment, capacity utilization, and the overall index of leading indicators all rose sharply. The rally in the stock and bond markets, the decline in the dollar, and the growth of employment are likely to provide a boost to demand in 1986. Moreover, inventories were quite lean at year-end, except for autos, so that increased strength in final sales is likely to be quickly translated into output.

Another development that could have very favorable effects on both inflation and economic growth in the forecast period is the recent drop in oil prices. The CBO forecast was completed in December, before the recent sharp declines. Some decline was assumed in the forecast. By early February, however, short-term futures prices for crude oil were in the $15 to $19 range per barrel--about $6 below the refiners' acquisition cost assumed in CBO's economic projection for mid-1986. Oil prices have been very volatile, however, and some of the decline could be reversed if oil producers agree on a new distribution of output quotas.

The Forecast for 1986 and 1987

The first two years of CBO's baseline economic projections are a "conditional" forecast based on specific policy assumptions:

- The Balanced Budget Act of 1985 is assumed to be fully implemented. The budget deficit is $208.3 billion in fiscal year 1986, well above the $171.9 billion target because the automatic spending cut is limited to $11.7 billion this year. For fiscal year 1987, the forecast assumes that the $144 billion deficit target will be attained.

- The preliminary target ranges for the levels of the narrower monetary aggregates announced last July are assumed to be adjusted somewhat to reflect actual experience through late 1985.

In addition, dollar exchange rates are assumed to decline this year, though less rapidly than in the second half of 1985. Oil prices are assumed to decline about 18 percent from from the last quarter of 1985 to mid-1986, and food prices are assumed to rise less than the general price level.

Given these assumptions, CBO expects inflation-adjusted GNP to grow 3.6 percent in 1986 and 3.0 percent in 1987 on a fourth-quarter-to-fourth-quarter basis (see Summary Table 2). The unemployment rate is projected to remain steady at 6.7 percent through calendar 1987. Inflation is expected to rise gradually in the forecast period. The three-month Treasury bill rate is expected to decline from 7.5 percent in 1985 to 6.7 percent in 1987.

Medium-Term Economic Projections

The projections for 1988-1991 are not a forecast of economic conditions, but assumptions based on average historical experience. Specifically, the growth rate for real GNP from the fourth quarter of 1982 to the fourth quarter of 1991 is assumed to equal the average growth rate in the nine-year periods following earlier postwar recessions. These outyear economic assumptions are not predicated on specific budget policies, and may not be consistent with the budget policies now in place. The major characteristics of the 1988-1991 projections are shown in Summary Figure 2:

- Real GNP grows moderately at an average rate of approximately 3.4 percent.
- The unemployment rate declines gradually to 6.0 percent by 1991.

SUMMARY TABLE 2. THE CBO FORECAST (Fourth-quarter-to-fourth-quarter growth rates)

	Actual		Projected	
	1984	1985	1986	1987
Nominal GNP	9.0	5.8	7.6	7.2
Real GNP	4.7	2.5	3.6	3.0
GNP Implicit Price Deflator	4.1	3.2	3.9	4.1
CPI-W	3.6	3.2	3.5	4.5

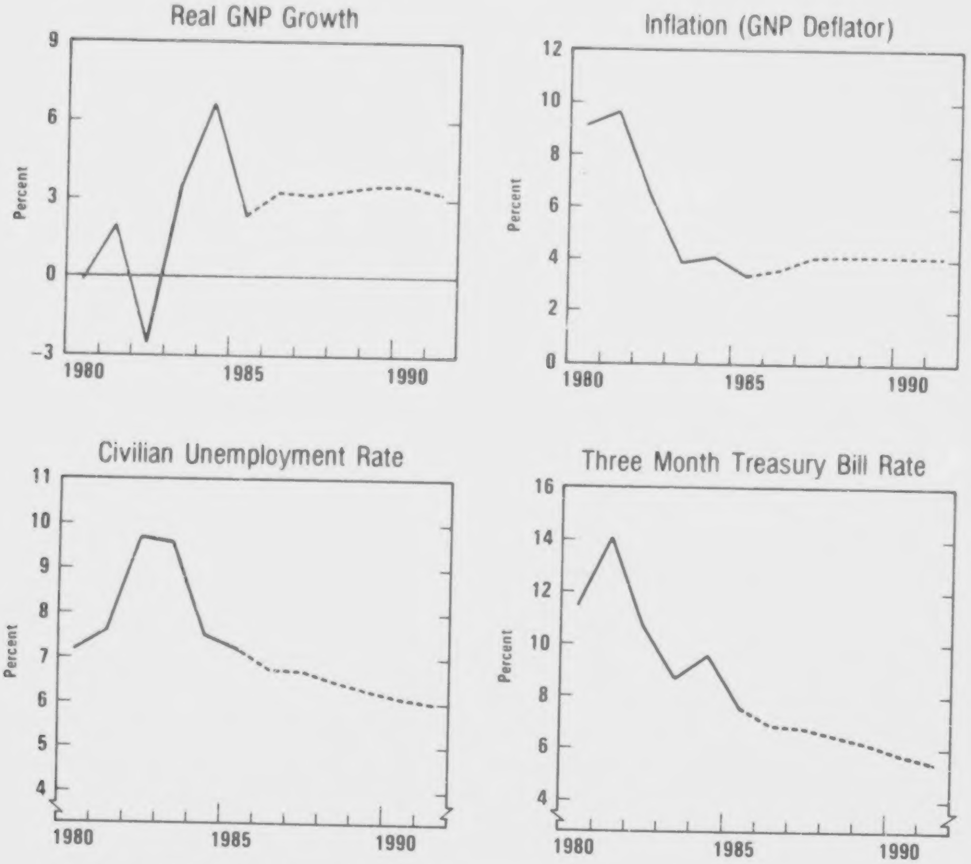
- Inflation, measured by the CPI-W, holds at about 4.3 percent over the projection period.
- Interest rates decline in the outyear projection. The three-month Treasury bill rate, for example, declines from 6.7 percent in 1987 to 5.4 percent in 1991.

Uncertainty in the Outlook

The performance of the economy could easily turn out to be much better or worse than CBO projects. The major uncertainties in the near term are

Summary Figure 2.

Major Economic Assumptions



SOURCES: Congressional Budget Office; U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

related to oil prices, the trade sector, financial conditions, and federal fiscal policy. Should oil prices remain low, inflation could be significantly lower and real output higher than projected by CBO. The recent decline in interest rates has greatly improved the financial status of many financial institutions and reduced the debt-service costs of developing countries. But some countries will be made worse off by the drop in oil prices and some financial institutions still suffer from poor-quality loans. For this reason, a financial crisis that would significantly raise risk premiums and interest costs cannot be ruled out.

Both the future course of the dollar and the response of net exports to the dollar's recent fall are difficult to predict. Some forecasters believe that foreign exporters will try to maintain their market shares by reducing profit margins rather than raising prices, thereby causing a delay in the response of U.S. imports to the depreciation of the dollar. Finally, the Balanced Budget Act may not be fully implemented, especially if constitutional challenges to the act are successful. Moreover, exactly how the deficit targets will be met is unclear. These uncertainties make it difficult to predict the short-run economic consequences of the projected turnaround in fiscal policy.

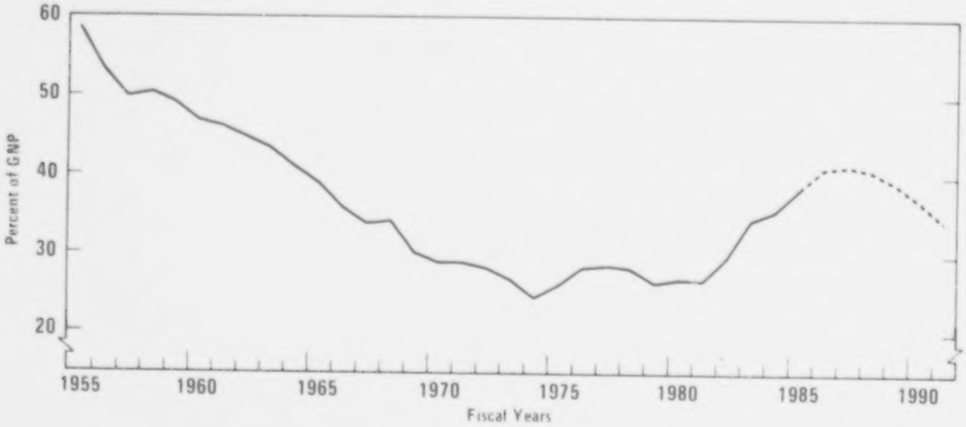
THE BUDGET OUTLOOK

Under CBO's baseline assumptions, which include no real growth in defense or nondefense appropriations, the total federal deficit would fall from $208 billion in 1986 to $181 billion in 1987 and $104 billion in 1991 (see Summary Table 1). The projected decline in baseline deficits parallels the deficit targets in the 1986 budget resolution, but falls increasingly short of the deficit targets in the Balanced Budget Act, which contemplates a zero deficit in 1991.

Over the next five years, revenues are projected to grow on average by 8 percent per year, slightly faster than the assumed average growth of the economy. On the other hand, outlays are projected to rise by an average of 4.8 percent per year, only slightly higher than the assumed rate of inflation. As a result, revenues would remain roughly constant as a percent of GNP, but federal outlays and the deficit would fall, as shown in Summary Figure 1.

The projected decline in budget deficits would slow the growth of federal debt and reduce the government's share of total credit demand. Under CBO's baseline assumptions, publicly held federal debt is projected to grow from $1.7 trillion by the end of 1986 to $2.4 trillion by the end of 1991.

Summary Figure 3.
Federal Debt Held by the Public



SOURCES: Congressional Budget Office; Office of Management and Budget; U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: The values shown for the 1986-1991 fiscal years are based on the assumption that the deficit targets of the Balanced Budget Act will be met.

In relation to GNP, debt held by the public would grow from 41.0 percent in 1986 to a peak of 42.7 percent in 1988 and then decline to 40.2 percent by the end of 1991. Of course, the decline in the debt-to-GNP ratio would be sharper if the Balanced Budget Act is implemented (see Summary Figure 3).

Changes in Baseline Projections

The budget outlook under baseline assumptions has changed dramatically from a year ago. In its 1985 annual report, and again in its update report last August, CBO projected that baseline deficits would rise from slightly more than $200 billion in 1985 to almost $300 billion by 1990. The basic change in the deficit outlook in this report has resulted from lower projections for spending, primarily for defense and nondefense discretionary programs and for net interest costs (see Summary Table 3).

CBO's baseline projections of last year assumed that defense appropriations would increase as specified in the 1985 budget resolution (and extended to 1990), at an average rate of 5½ percent in real terms--after adjustments for projected inflation. The 1986 budget resolution specified zero real growth for defense appropriations in 1986 and 3 percent real growth thereafter. Actual 1986 defense appropriations, however, fell short of the budget resolution target, and the 1986 sequestration will reduce the amount of new budget authority even further, to below the 1985 level. CBO's latest baseline projections assume zero real growth in defense appropriations from the 1986 post-sequestration level. Because the Balanced Budget Act lowered the outyear deficit targets contained in the 1986 budget resolution, the assumptions of the resolution can no longer be taken as necessarily representing current Congressional policy. The combination of these factors reduces projected defense outlays by $250 billion for 1986 through 1990 compared with CBO's baseline projections of last August.

Even with 3 percent real growth in defense appropriations in 1987 and beyond, baseline deficits would decline over the next five years, although not as sharply. Instead of baseline deficits declining from $208 billion in 1986 to $104 billion in 1991, they would decline to $150 billion.

SUMMARY TABLE 3. CHANGES IN CBO BASELINE DEFICIT PROJECTIONS SINCE AUGUST 1985
(By fiscal year, in billions of dollars)

Major Changes	1986	1987	1988	1989	1990
August 1985 Baseline Deficit	212	229	243	264	285
Major Changes:					
Lower defense outlays	-9	-26	-48	-71	-96
Lower nondefense discretionary program outlays	-10	-19	-20	-21	-22
Lower net interest costs	a/	-7	-16	-31	-51
Other outlay changes	6	-4	-4	-8	-12
Lower revenues	9	9	10	11	16
Total changes	-4	-48	-78	-120	-165
February 1986 Baseline Deficit	208	181	165	144	120

SOURCE: Congressional Budget Office.

a. Less than $500 million.

The latest baseline projections for nondefense discretionary programs are also lower than those made last year, reflecting reductions made in 1986 appropriations and the effects of the 1986 sequestration. The reduction from CBO's baseline projections of last August is almost $92 billion for the five-year period 1986-1990.

CBO's latest short-term forecast and long-run economic assumptions also feature lower interest rates than assumed last year. These lower rates, together with a reduction in debt service costs because of other changes, reduce net interest outlays by over $100 billion for 1986-1990 compared with last August's baseline projections. Relatively small changes in baseline deficits result from revised projections for farm price supports and Medicare and other entitlement programs, and from slightly lower projected revenues.

Alternative Projections

To show how changes in economic assumptions can affect budget outcomes, CBO has prepared two alternative sets of projections (see Summary Table 4). They are intended to illustrate what could happen if economic growth turns out to be higher or lower than projected over the next six years.

The high path assumes growth almost equal to that of the strongest nine-year expansion of the postwar period, which occurred after the recession of 1957-1958. Because the pace of economic expansion up to now has been close to that in an average recovery pattern, this path implies unusually strong growth from now through 1991. As a result, unemployment falls to 4.6 percent in 1991, while the inflation rate more than doubles. Interest rates also rise sharply after 1988, paralleling the higher inflation rate.

The low path incorporates a recession starting in 1987, which has the depth and duration of the 1973-1975 recession, and is followed by an average economic recovery. The weaker growth results in lower inflation and lower interest rates than in the CBO economic assumptions after 1987, and higher unemployment rates.

Under the high-growth economic assumptions, the deficit drops swiftly to near balance by 1990 and a sizable surplus in 1991. Under the low-growth assumptions, however, the deficit grows sharply. For example, in fiscal year 1989, the year following the recession incorporated in the low-growth path, the deficit is more than $125 billion above the CBO baseline projection.

AUTOMATIC SPENDING REDUCTIONS

If the Congress fails to reduce the 1987 deficit to $144 billion before the start of the fiscal year, an automatic procedure could be invoked that would make the reduction by sequestering budgetary resources. Under CBO's February assumptions, a 1987 sequestration would reduce total outlays to $989 billion--$37 billion below the baseline projection. As shown in Summary Table 5, there would be almost no growth in total outlays beyond the 1986 estimated level of $986 billion.

SUMMARY TABLE 4. ALTERNATIVE ECONOMIC AND BUDGET PROJECTIONS

	1986	1987	1988	1989	1990	1991
Economic Projections (By calendar year)						
Real GNP (percent change)						
High-growth alternative	4.0	4.3	4.4	4.6	4.6	4.6
Baseline	3.2	3.1	3.3	3.5	3.5	3.2
Low-growth alternative	3.0	-0.7	-0.8	5.4	3.4	3.2
CPI-W (percent change)						
High-growth alternative	3.4	4.3	5.2	6.3	7.5	9.1
Baseline	3.4	4.2	4.4	4.4	4.3	4.3
Low-growth alternative	3.6	4.4	3.9	3.0	2.5	2.5
Civilian Unemployment Rate						
High-growth alternative	6.6	6.3	5.8	5.5	5.1	4.6
Baseline	6.7	6.7	6.5	6.3	6.1	6.0
Low-growth alternative	6.9	8.4	9.9	8.9	8.8	8.7
Three-Month Treasury Bill Rate						
High-growth alternative	6.5	6.1	7.5	8.5	9.7	11.1
Baseline	6.8	6.7	6.4	6.1	5.7	5.4
Low-growth alternative	7.6	7.7	5.9	5.6	4.9	4.3
Budget Projections (By fiscal year, in billions of dollars)						
Deficit (-) or Surplus						
High-growth alternative	-202	-154	-111	-61	-1	70
Baseline	-208	-181	-165	-144	-120	-104
Low-growth alternative	-210	-224	-282	-271	-238	-237

SOURCE: Congressional Budget Office.

The sequestration procedures under the Balanced Budget Act for 1987 would begin in August 1986 when CBO and the Office of Management and Budget send their initial budget estimates either to the Comptroller General or to a special joint committee of the Congress. The CBO estimates presented in this report are made for illustrative purposes and are subject to significant revision over the next six months as the result of legislative actions, changes in the economic outlook, and other factors. These estimates show that relying on the sequestration procedures to reach the $144 billion deficit amount for 1987 would mean reductions of $18 billion in outlays for defense programs and $17 billion for nondefense programs from CBO's projected baseline levels, which include the effects of the 1986

SUMMARY TABLE 5. EFFECT OF SEQUESTRATIONS ON BUDGET OUTLAYS FOR 1986 AND 1987 (By fiscal year, in billions of dollars)

Category	1986	1987
Defense Programs a/		
Presequester baseline levels	275	293
1986 sequester	269	284
1987 sequester	269	266
Nondefense Programs b/		
Presequester baseline levels	618	639
1986 sequester	612	632
1987 sequester	612	615
Net Interest and Undistributed Offsetting Receipts c/		
Presequester baseline levels	105	111
1986 sequester	104	109
1987 sequester	104	107
Total Outlays		
Presequester baseline levels	998	1,043
1986 sequester	986	1,025
1987 sequester	986	989

SOURCE: Congressional Budget Office.

a. Budget function 050, national defense.
b. Budget functions 150 through 850, and 920.
c. Budget functions 900 and 950.

sequestration. The result would be to hold outlays for both defense and nondefense programs to roughly the same levels as estimated for 1986.

To achieve these outlay reductions, defense appropriations for 1987 would have to be reduced 6.2 percent below 1986 post-sequestration levels, and nondefense discretionary appropriations would have to be cut by 8.4 percent. The reductions in real terms would be even greater because of the loss of any adjustment for inflation in 1987. For defense programs, new budget authority for 1987 would be limited to $271 billion, which is $30 billion below CBO's baseline projection and $49 billion below the Administration's budget request.

CHAPTER I

THE ECONOMIC OUTLOOK

In 1985, the U.S. economy experienced its third full year of recovery and expansion following the recession of 1981-1982. The pace of expansion slowed noticeably, however, compared with the two preceding years. Most forecasters expect growth to pick up again during 1986, in part because of major turnabouts in government policies and in commodity markets that occurred late last year. The Congress passed major legislation to eliminate the federal budget deficit over a six-year period beginning in 1986. This action appears to have contributed to the rally in the bond and stock markets, which carried long-term interest rates to their lowest levels in six years and raised stock prices to record levels. In response to falling U.S. interest rates, as well as to concerted action by governments of major industrialized countries, the international value of the dollar posted its first sustained decline in several years. Finally, late in 1985 the price of oil began to drop sharply. As this report went to press, real oil prices were at levels below those of the mid-1970s.

THE ECONOMIC OUTLOOK

The current Congressional Budget Office (CBO) economic forecast is much like that of last August. The outlook is still for moderate economic growth in 1986 and 1987 of 3 percent to 4 percent annually. CBO also expects inflation to be somewhat lower than it anticipated last August.

The CBO economic projections are composed of two parts: a short-term forecast for the 1986-1987 period, which is contingent on specific fiscal and monetary policies described below; and a set of medium-term projections for the period 1988-1991. It is important to note, however, that the figures for 1988-1991 are not forecasts of probable economic behavior, but rather a projection of how the economy would evolve during that period if it followed historical trends. 1/

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1. The Commerce Department has recently released a major benchmark revision of the National Income and Product Accounts. This revision makes a number of conceptual changes, and rebases real spending from 1972 dollars to 1982 dollars (see Box I-1 for a detailed description of the revision and its implications). CBO's economic projection uses the revised figures.

The Short-Term Forecast

CBO's forecast for 1986 and 1987 is based on the following assumptions about economic policy and other developments:

- The budget deficit targets of the Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177) are assumed to be fully implemented. Although the deficit target is $171.9 billion for fiscal year 1986, the legislation limits the size of the sequestration (automatic spending cut) in fiscal year 1986 to a maximum of $11.7 billion. Since CBO projections show that the deficit would be $220 billion if no cuts were made, the fiscal year 1986 unified budget deficit is assumed to be $208 billion (see Chapter II). The act imposes no cap on sequestration for later years. Consequently, the deficit for fiscal year 1987 is assumed to be at the target of $144 billion.

- The preliminary target ranges announced last July for the levels of the narrower monetary aggregates are assumed to be adjusted upward somewhat to reflect actual experience through late 1985.

- Food prices are expected to increase less than the general price level.

- The international value of the dollar is assumed to continue to decline, though less rapidly than in the last three months.

- The price (refiners' acquisition cost) of imported oil is assumed to fall about 18 percent between the last quarter of 1985 and mid-1986.

Given the assumptions described above, CBO expects real GNP to grow 3.6 percent between the fourth quarters of 1985 and 1986 and 3.0 percent during 1987 (see Table I-1). It also anticipates that the civilian unemployment rate will average 6.7 percent over 1986 and 1987.

The inflation rate (measured by the change in the implicit GNP deflator) is expected to increase from 3.2 percent over the four quarters of 1985 to 3.9 percent during 1986 and 4.1 percent during 1987. The Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) is forecast to rise 3.5 percent in 1986 and 4.5 percent in 1987.

Interest rates are expected to decline modestly in 1986. Rates on three-month Treasury bills are forecast to fall from 7.5 percent last year to

6.8 percent in 1986 and 6.7 percent in 1987. Rates on 10-year government bonds are expected to fall from 10.6 percent in 1985 to 9.0 percent in 1986 and 8.9 percent in 1987. This implies a flattening of the yield curve and also substantially lower short- and long-term real interest rates than have prevailed so far in the economic recovery.

Several factors underlie the expectation of continued economic growth in 1986 and 1987:

- The recent decline in long-term interest rates should provide a favorable environment for investment. Residential investment is forecast to exceed 1985 levels. Lower real interest rates and continued underlying strength in consumer demand should also encourage businesses to invest in new plant and equipment, though the rate of growth in business investment is expected to slow in 1986 and later years.

- Inventories generally do not appear to be excessive after more than a year of reduced rates of inventory accumulation. Moreover, lower interest rates should reduce the costs of holding

TABLE I-1. THE CBO FORECAST FOR 1986 AND 1987 (In percents)

Economic Variable	Actual 1984	Actual 1985	Forecast 1986	Forecast 1987
Fourth Quarter to Fourth Quarter				
Nominal GNP a/	9.0	5.8	7.6	7.2
Real GNP a/	4.7	2.5	3.6	3.0
Implicit GNP Deflator a/	4.1	3.2	3.9	4.1
CPI-W	3.6	3.2	3.5	4.5
Calendar-Year Averages				
Civilian Unemployment Rate	7.5	7.2	6.7	6.7
3-Month T-Bill Rate	9.5	7.5	6.8	6.7
10-Year Government Bond Rate	12.4	10.6	9.0	8.9

a. Projected growth rates are assumed to be similar on a prebenchmark and postbenchmark basis.

inventories, leading some forecasters to predict that businesses will increase their inventory stocks.

- The recent decline in the international value of the dollar should lead to an eventual improvement in the trade balance.

- Lower energy prices are expected to increase real incomes, stimulating the growth of consumption and investment.

In 1986, inflation is expected to rise only slightly. Greater price increases in some sectors are largely offset by the weakness in the prices of oil and other commodities, continued excess industrial capacity, and slack in labor markets. But a continuing decline of the dollar, coupled with the possibility that there will be delayed effects of the large increases in the money supply that have occurred over the last year, may put upward pressure on prices in 1987.

Forecasts for real growth and inflation in 1986 and 1987 are highly uncertain, particularly in light of possible further large movements in energy prices and in the dollar. In early February short term oil price futures were below the refiners' acquisition cost assumed in CBO's forecast for mid-1986 by roughly $6 per barrel. Prices remained volatile, however, and market analysts were split as to whether prices might fall further or regain some lost ground. These uncertainties are discussed further in the sections below.

The Medium-Term Economic Projections

CBO's projections for 1988 through 1991, shown in Tables I-2 and I-3, are not forecasts of economic performance, nor are they necessarily exactly consistent with future economic policies. Instead, they show what the economy's course would be if it were to follow longer-term historical trends in real growth. Nine years separate the most recent recession trough from the last quarter of 1991. On average, since World War II, the annual growth rate of real GNP over such nine-year periods has been 3.7 percent. The CBO projection closely approximates this result.

Such nine-year periods have usually contained at least one new recession, and the current projections allow for a mild downturn. Because of the great uncertainty regarding the timing of business cycles, however, CBO has made no attempt to forecast when that downturn might occur. Instead, the growth rate has been smoothed in the projections so that it averages about 3.5 percent per year from 1988 through 1990. After that, growth slows as the unemployment rate approaches levels at which many economists would expect labor markets to tighten.

The projections show inflation (measured by the implicit GNP deflator) averaging slightly above 4 percent over the 1988-1991 period. Real interest rates are assumed to decline over those years, a reflection of the assumed effect of lower federal deficits under current law. The projections assume that lower federal deficits may also reduce the need for capital inflows from abroad, which will allow the exchange rate to fall and bring about a long-run improvement in net exports.

Behavior of the Tax Base. CBO's projections of federal revenues depend in part on how wages, profits, interest payments, and other incomes are projected to behave. The share of wages and salaries in GNP is expected to remain roughly constant through 1991. Underlying this flattening of the recent downward trend is the assumption that real wages, which have been weak for several years, will grow at a rate that approaches the rate of growth of productivity. The share of nonwage income (proprietors' income, rental income, personal dividend and interest income) in GNP is assumed to fall, primarily because lower interest rates and a lower federal deficit reduce personal interest income. The share of profits in GNP is increased by the reduction in corporate interest expense, and by an assumed slower growth in employer contributions for health insurance and for pension funds. 2/

Sources of Uncertainty. Medium-term projections are necessarily quite uncertain. CBO's projections assume that there will be no major positive or negative supply shocks after 1987, such as those that might result from massive oil price changes in either direction or large crop surpluses or crop failures. The projections also include assumptions about labor force participation rates that have proved quite unreliable in the past. Moreover, for reasons not fully understood, the growth rate of labor productivity has been below average since the late 1970s. The CBO projection assumes that the relation between real growth and worker hours will approximate the postwar experience, and thus incorporates some improvement in this area. There is a risk, however, that productivity growth will follow its more recent trend rather than the higher path that CBO assumes.

The performance of the economy over the medium term will also depend on the policies pursued by the Federal Reserve, as well as on domestic fiscal policy and its repercussions. If, for example, the Federal Reserve were to follow a policy of gradually reducing the annual growth rate of the money supply, it could cause the growth rate of nominal GNP

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2. Recent Internal Revenue Service regulations permitting "cafeteria" benefit plans are not reflected in the economic projections, but are incorporated in the revenue projections described in Chapter II.

TABLE I-2. MEDIUM-TERM ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1988-1991

Economic Variable	Actual	Forecast		Projected			
	1985	1986	1987	1988	1989	1990	1991
GNP (billions of current dollars) a/	3,993	4,269	4,583	4,930	5,313	5,725	6,152
Nominal GNP Growth (percent change) a/	5.8	6.9	7.3	7.6	7.8	7.8	7.5
Real GNP Growth (percent change) a/	2.3	3.2	3.1	3.3	3.5	3.5	3.2
Implicit GNP Deflator (percent change) a/	3.3	3.6	4.1	4.1	4.1	4.1	4.1
CPI-W (percent change)	3.5	3.4	4.2	4.4	4.4	4.3	4.3
Civilian Unemployment Rate (percent)	7.2	6.7	6.7	6.5	6.3	6.1	6.0
Three-Month Treasury Bill Rate (percent)	7.5	6.8	6.7	6.4	6.1	5.7	5.4
Ten-year Government Bond Rate (percent)	10.6	9.0	8.9	8.2	7.5	6.8	6.1
Corporate Profits (percent of GNP)	7.5	8.1	8.1	8.2	8.2	8.1	7.9
Wage and Salary Disbursements (percent of GNP)	49.1	49.1	49.1	49.0	48.8	48.8	48.9
Other Taxable Income (percent of GNP)	19.8	19.3	19.2	19.1	19.0	18.9	18.8

SOURCE: Congressional Budget Office.

a. Projected growth rates are assumed to be similar on a prebenchmark and postbenchmark basis, starting with the first quarter of 1986.

TABLE I-3. MEDIUM-TERM ECONOMIC PROJECTIONS FOR FISCAL YEARS 1988-1991

Economic Variable	Actual	Forecast		Projected			
	1985	1986	1987	1988	1989	1990	1991
GNP (billions of current dollars) a/	3,937	4,192	4,504	4,838	5,214	5,619	6,047
Nominal GNP Growth (percent change) a/	6.5	6.5	7.4	7.4	7.8	7.8	7.6
Real GNP Growth (percent change) a/	2.9	3.0	3.3	3.2	3.5	3.5	3.4
Implicit GNP Deflator (percent change) a/	3.6	3.4	4.0	4.1	4.1	4.1	4.1
CPI-W (percent change)	3.5	3.3	3.9	4.4	4.4	4.3	4.3
Civilian Unemployment Rate (percent)	7.2	6.8	6.7	6.5	6.3	6.2	6.0
Three-Month Treasury Bill Rate (percent)	7.9	6.9	6.7	6.5	6.2	5.8	5.5
Ten-year Government Bond Rate (percent)	11.1	9.2	8.9	8.4	7.7	7.0	6.3
Corporate Profits (percent of GNP)	7.3	7.9	8.2	8.1	8.2	8.1	8.0
Wage and Salary Disbursements (percent of GNP)	49.0	49.1	49.1	49.0	48.9	48.8	48.8
Other Taxable Income (percent of GNP)	20.0	19.4	19.2	19.1	19.0	18.9	18.8

SOURCE: Congressional Budget Office.

a. Projected growth rates are assumed to be similar on a prebenchmark and postbenchmark basis, starting with the first quarter of 1986.

and the rate of inflation to decline in the projection period rather than staying constant, as in CBO's projections. It is uncertain whether such lower nominal GNP growth could be achieved without also reducing that of real GNP below the projected rate.

Finally, achieving the deficit reductions called for in the Balanced Budget and Emergency Deficit Control Act of 1985 will require major changes in federal purchases, transfers, subsidies, and perhaps also taxes. There is great controversy within the economics profession about the impact of such fiscal policy changes, and it is possible that they could make the economy grow more slowly than CBO projects.

Alternative Projections

To show how changes in economic assumptions can affect budget outcomes, CBO has prepared two alternative sets of economic projections that are intended to illustrate what could happen if economic growth turned out to be higher or lower than projected (see Table I-4 and Figure I-1). They should not be seen as limits to the range of likely growth rates, since for a short period economic growth could move outside this range.

The high path assumes that average real GNP growth through 1991 is 1.2 percentage points higher than in CBO's baseline projection. This puts real GNP at the end of 1991 some 49 percent above its value at the recession trough in the final quarter of 1982, the same increase as that experienced in the strongest nine-year expansion of the postwar period, which occurred after the recession of 1957-1958. Because the pace of economic expansion up to now has been close to that in the average recovery pattern, this path implies unusually strong growth from now through 1991. As a result, the unemployment rate falls to 4.6 percent in 1991, well below the level at which most economists would expect inflation to pick up, causing the inflation rate to more than double over the projection period. Interest rates rise sharply higher than in CBO's baseline economic projection after 1988, reflecting both higher inflation and efforts by the monetary authorities to restrain it.

The low path assumes a recession starting in 1987. The recession has approximately the depth and duration of that experienced in 1973-1975, and is followed by an average economic recovery. 3/ The unemployment rate

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3. CBO's baseline projections are constructed in a way that does not rule out a minor recession. The low-path alternative differs in that the recession is unusually large, and also that a specific date for the recession is assumed.

TABLE I-4. ALTERNATIVE ECONOMIC PROJECTIONS (By calendar year)

	1986	1987	1988	1989	1990	1991
GNP (billions of dollars) a/						
High	4,305	4,687	5,141	5,706	6,410	7,312
Baseline	4,269	4,583	4,930	5,313	5,725	6,152
Low	4,264	4,424	4,517	4,903	5,179	5,459
Real GNP (percent change) a/						
High	4.0	4.3	4.4	4.6	4.6	4.6
Baseline	3.2	3.1	3.3	3.5	3.5	3.2
Low	3.0	-0.7	-0.8	5.4	3.4	3.2
Implicit Price Deflator (percent change) a/						
High	3.7	4.3	5.0	6.1	7.4	9.1
Baseline	3.6	4.1	4.1	4.1	4.1	4.1
Low	3.7	4.5	2.9	3.0	2.2	2.1
CPI-W (percent change)						
High	3.4	4.3	5.2	6.3	7.5	9.1
Baseline	3.4	4.2	4.4	4.4	4.3	4.3
Low	3.6	4.4	3.9	3.0	2.5	2.5
Unemployment Rate (percent)						
High	6.6	6.3	5.8	5.5	5.1	4.6
Baseline	6.7	6.7	6.5	6.3	6.1	6.0
Low	6.9	8.4	9.9	8.9	8.8	8.7
3-Month Treasury Bill (percent)						
High	6.5	6.1	7.5	8.5	9.7	11.1
Baseline	6.8	6.7	6.4	6.1	5.7	5.4
Low	7.6	7.7	5.9	5.6	4.9	4.3

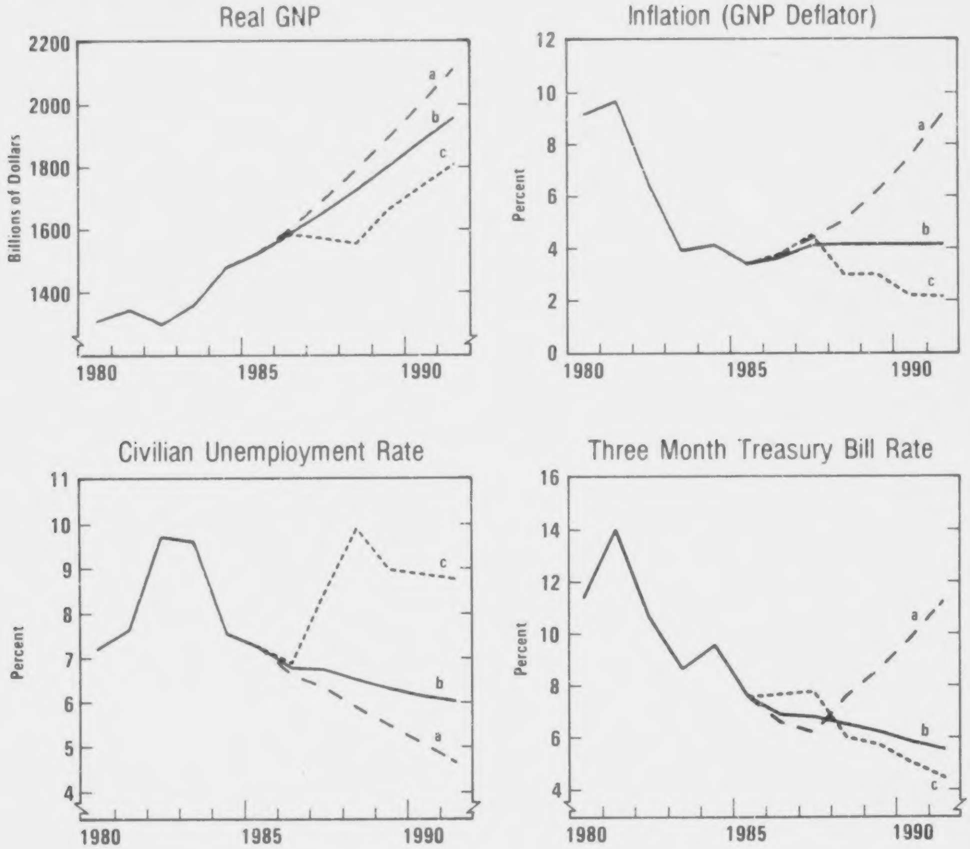
SOURCE: Congressional Budget Office.

a. Projected growth rates are assumed to be similar on a prebenchmark and postbenchmark basis, starting with the first quarter of 1986.

rises to 9.9 percent in 1988 and remains at 8.7 percent in 1991. The inflation rate, which is assumed to rise slightly above its baseline level just before the recession, drops to 2.1 percent in 1991. Interest rates are assumed to remain high during most of the recession, but to drop afterward, reflecting the lower inflation rate. After adjusting the three-month Treasury bill rate for inflation, however, the resulting real interest rate is still almost a full percentage point above its baseline value.

Figure I-1.

Alternative Economic Assumptions



Real GNP

Inflation (GNP Deflator)

Civilian Unemployment Rate

Three Month Treasury Bill Rate

SOURCES: Congressional Budget Office; U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

[a] High path.

[b] Baseline.

[c] Low path.

FISCAL AND MONETARY POLICY

The federal deficit reached record levels in 1985, and the monetary aggregates grew rapidly. But the prospects for reducing future federal deficits were enhanced by passage of the fiscal year 1986 budget resolution and the Balanced Budget Act. The changed outlook for budget deficits probably contributed to the decline in long-term interest rates that occurred late in the year.

Fiscal Policy

Fiscal policy became highly expansionary during the 1980s, with the federal deficit increasing severalfold to a level of more than $200 billion. Now the outlook is for a shift to substantial restraint beginning next year (see Figure I-2 and Table I-5). Under the Balanced Budget Act, the deficit (including off-budget outlays) is to be reduced from about $208 billion in 1986 to a balanced budget in 1991. The decline in the deficit will be particularly sharp in 1987 when the target deficit is $144 billion, an estimated $64 billion decline from the previous year's level. After that, the target will decline by $36 billion per year. To the extent that discretionary tax increases and spending reductions fail to bring the estimated deficit down to the required level, changes in budget policy will be achieved by sequestration--that is, across-the-board reductions in specified defense and nondefense spending categories. There are provisions in the Balanced Budget Act making it possible for the Congress and the President to suspend sequestration temporarily in the event of a significant economic slowdown or an anticipated recession. 4/

While budget estimates are very sensitive to economic conditions, it appears that achieving the deficit targets would not only balance the budget but would also eventually eliminate the structural (or standardized-employment) deficit (see Table I-5 and Figure I-2). The structural deficit--the total deficit calculated at a constant unemployment rate of 6 percent--is projected to reach a record level of $162 billion in 1986, but to decline steadily thereafter to an approximate balance by 1991. The structural deficit falls from 4.0 percent of standardized GNP to zero over this period.

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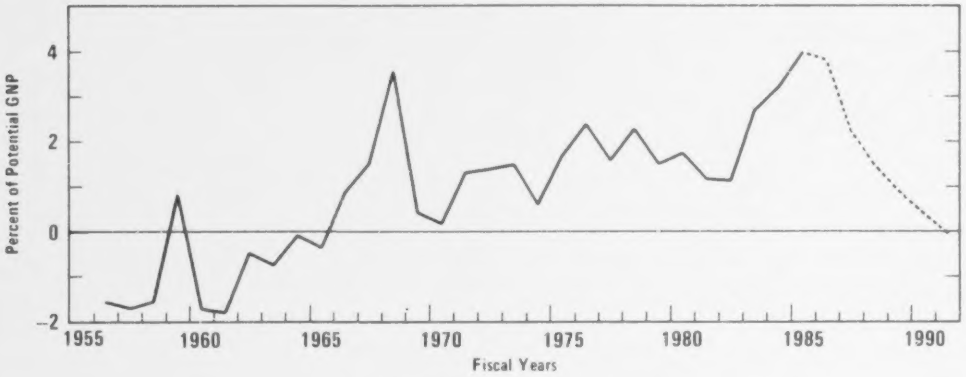
4. The new law and the effect of a recent court decision are discussed in Chapter III.

The new law would also reduce the ratio of the federal debt to GNP--a measure of the burden of the public debt (Figure I-2 and Table I-5). This ratio is projected to begin declining after 1987, the first sustained decline in over a decade. By 1991, the federal debt would drop below 35 percent of GNP, roughly offsetting the increase since 1983 but still substantially above the postwar low of about 25 percent.

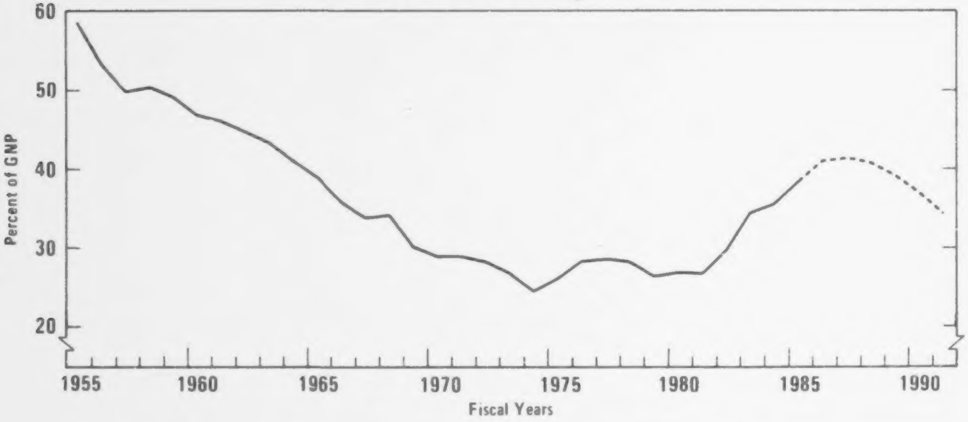
Figure I-2.

Measures of Fiscal Policy

Standardized Employment Deficit



Federal Debt Held by Public



SOURCES: Congressional Budget Office; Office of Management and Budget; U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: The values shown for the 1986-1991 fiscal years are based on the assumption that the deficit targets of the Balanced Budget Act will be met.

Long-Run Effects of Deficit Reductions. The gap between net domestic saving and net private domestic investment increased dramatically in the first half of the 1980s, as the rate of net private domestic saving fell while federal deficits soared. The difference was made up by rising net foreign investment in the United States, mirrored in record-breaking deficits in the balance of trade. In February 1985, CBO calculated that, if federal deficits

TABLE I-5. AGGREGATE MEASURES OF FISCAL POLICY
(Fiscal years)

Measure	1985	1986	1987	1988	1989	1990	1991
				Billions of Dollars			
Standardized Employment Deficit							
Baseline	161	162	140	128	118	107	103
Balanced-budget target a/	161	162	102	71	46	23	-1
Publicly Held Debt							
Baseline	1,510	1,720	1,900	2,064	2,207	2,326	2,429
Balanced-budget target	1,510	1,720	1,863	1,970	2,041	2,076	2,075
				Percent of GNP			
Standardized Employment Deficit b/							
Baseline	4.0	3.8	3.1	2.7	2.3	1.9	1.7
Balanced-budget target	4.0	3.8	2.3	1.5	0.9	0.4	0.0
Publicly Held Debt c/							
Baseline	38.4	41.0	42.2	42.7	42.3	41.4	40.2
Balanced-budget target	38.4	41.0	41.4	40.7	39.1	36.9	34.3

SOURCE: Congressional Budget Office.

a. Assumes full implementation of the Balanced Budget and Emergency Deficit Control Act of 1985.

b. Percent of standardized GNP.

c. Percent of GNP.

were to average 4.6 percent of GNP over the 1985-1990 period, net foreign investment would have to reach about 2.4 percent of GNP just to sustain a fairly modest level of net private domestic investment of 6.4 percent of GNP. 5/

The deficit targets contained in the Balanced Budget Act radically alter the outlook for savings and investment for the next six years (Table I-6). The deficit is now projected to average 1.9 percent of GNP. As a result, even with the net private domestic saving rate remaining at the relatively low level of the last five years, net private domestic investment could rise to 6.7 percent of GNP, near its 1950-1985 average, requiring net foreign investment in the U.S. of only 0.9 percent of GNP.

Earlier CBO reports and other studies discussed in detail the adverse long-run effects of persistent large deficits. 6/ That analysis implied that the reduction in government dissaving should have the following beneficial effects on the economy.

- As the deficit shrinks, the federal debt will grow more slowly. Eventually, the debt will decline relative to GNP. A lower federal debt/GNP ratio will allow more room for growth of private debt to finance capital formation, leading to higher productivity. The end result will be higher living standards for future generations than would otherwise be possible.
- Shrinking federal deficits will make the country less dependent on capital inflows from abroad. To the extent that foreign capital has financed government spending on consumption goods rather than productive investment, this will improve future domestic living standards by reducing debt service obligations to foreigners.

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5. This calculation was based on unrevised NIPA data. It assumed recovery of net private domestic saving to the level of 7.2 percent of GNP prevailing in the 1970s, with state and local surpluses remaining at their high plateau of 1.4 percent of GNP recorded in 1984. The revised NIPA data imply that, because of more net private domestic saving, a slightly higher rate of net private domestic investment could have been achieved with the same deficit figures and smaller net inflows of foreign savings. See *The Economic and Budget Outlook: Fiscal Years 1986-1990* (February 1985), Chapter III, pp. 79-113.

6. See, for example, *The Economic and Budget Outlook: Fiscal Years 1986-1990* (February 1985), Chapter 3, pp. 79-113; and Frederick Ribe and William J. Beeman, *Effects of the Fiscal Monetary Policy Mix on Long-Run Growth in an Open Economy*, forthcoming in the *Papers and Proceedings of the American Economic Association*, May 1986.

TABLE I-6. NET SAVINGS AND INVESTMENT FLOWS AS PERCENT OF GNP (NIPA basis)

Period	(1) Net Private Domestic Savings	(2) State and Local Surplus	(3) Federal Deficit	(4) Net Domestic Savings Available for Domestic Investment: (1) + (2)-(3)	(5) Net Private Domestic Investment	(6) Net Domestic Savings Shortfalls (5)-(4) = Net Foreign Investment
1950-1959	7.5	-0.2	-0.1	7.4	7.5	0.1
1960-1969	8.1	0.0	0.3	7.9	7.1	-0.8
1970-1979	8.1	0.8	1.7	7.1	6.9	0.3
1980-1985	6.4	1.3	4.0	3.7	4.7	1.0
Average						
1950-1985	7.6	0.4	1.2	6.8	6.7	-0.1
1986-1991 a/	6.4	1.3	1.9	5.8	6.7	0.9

SOURCES: Congressional Budget Office; U.S. Department of Commerce, Bureau of Economic Analysis.

a. Net private domestic savings and state and local surplus are assumed for illustrative purposes to be at their averages for 1980-1985, while net private domestic investment is assumed to be at its 1950-1985 average. The federal deficit is calculated using the Balanced Budget Act targets and assuming the targets are met through spending or tax changes and not through asset sales or changes in lending programs. Columns 4 and 6 are calculated from the other figures.

- The reduction in capital inflows would allow the exchange rate of the dollar to depreciate further. This depreciation, in turn, would increase the competitiveness of U.S. goods on world markets, improving output and employment in manufacturing and other sectors that have been depressed for several years because of the high dollar.

- Shrinking deficits will sharply reduce the danger of explosive growth in federal interest payments and the stock of federal debt, far in excess of GNP growth. If this were to occur, it could leave little choice but to monetize a large part of the debt. Hyperinflation would then be almost inevitable.

- Even without an explosive increase in the debt, some believe that high deficits might induce the Federal Reserve to monetize a larger portion of the federal debt simply to prevent interest rates from being too high. While the evidence of a tendency to monetize debt is inconclusive, the mere possibility may nurture fears of inflation that keep interest rates higher than they would be otherwise.

- Finally, moving toward a balanced budget will restore a margin of safety should heavy deficit financing of government expenditures become necessary in a war or other national emergency.

Short-Run Effects of Deficit Reductions. While most people agree that a sizable reduction of budget deficits will have a long-term salutary effect on the economy, some analysts fear that such reduction, if done too abruptly, might temporarily weaken the overall economy. Reducing the deficit means reducing federal purchases and transfers and perhaps increasing taxes. Such actions would reduce demands of businesses and individuals whose incomes are reduced directly or indirectly by budget cuts. 7/ Curtailment of aggregate demand is likely to reduce output and employment in the short run if it is done too quickly. The greatest risk of a temporary slowdown in business activity appears to be in 1987, when the structural deficit is estimated to decline by $60 billion from the previous year's level, or by 1.5 percent of standardized GNP.

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7. These demand reductions could be relatively severe during the next few years because consumers' estimates of their long-term incomes and businesses' estimates of long-term demand for their products might be curtailed relatively sharply by the outlook for repeated federal budget reductions.

In the current situation, however, several factors are likely to mitigate these risks:

- Some analysts believe that any short-run economic weakening caused by federal budget cuts would be offset by the effect of anticipated multiyear deficit reductions in reducing long-term interest rates. In response to interest-rate declines, business investment and other types of interest-sensitive private spending should increase after some lag. In the current situation, investment spending may be accelerated because the interest-rate declines have come even before any budget cuts have been implemented. (See the interest-rate discussion in the next section.)

- As fiscal expansion is replaced by fiscal restraint, the trade balance should start improving after some lag. This should eventually help to offset any weakening of the economy.

- Some observers would add monetary policy to this list, believing that the Federal Reserve should raise the growth of monetary aggregates if the growth of nominal GNP begins to slacken as deficits are reduced. Others believe that the central bank should confine its role to ensuring that the money aggregates are kept growing at a steady pace, letting interest rates go where they will--very probably downward in the face of deficit reduction. Those favoring a more passive role for monetary policy often do so because they think that the aggregate demand effects of fiscal policy changes are very small or because they believe that economists are so ignorant of the relative strength of monetary and fiscal policy and the time lags with which they work that an activist monetary policy is as likely to do harm as good.

Consequences of Fixed Deficit Targets. The passage of the Balanced Budget Act means a dramatic change in the fiscal outlook, not only because it increases the probability that budget deficits will be significantly reduced, but also because it sets firm targets for several years to come. Advocates of such preannounced deficit targets (including a balanced budget) have maintained for years that deficits reinforce the tendency toward excessive growth of federal spending. The cost of debt-financed spending, they argue, is not readily apparent and tends therefore to be discounted by the electorate. The advantage of having deficit targets written into law, according to this view, is that spending initiatives that push the deficit above the mandated target have to be financed with tax increases, and policymakers are reluctant to raise taxes. Thus, deficit targets may impose tighter discipline on budget decisions.

Opponents of fixed deficit targets have stressed that the targets will have the undesirable effect of eliminating the automatic stabilizing effects of cyclical deficits. Deficit increases that result automatically from a slowdown in economic growth are known as "automatic stabilizers" because they help stimulate private spending and cushion the economic slowdown. Firm adherence to deficit targets would do away with the automatic stabilizers. Indeed, the adverse consequences of an economic shock--such as a sudden decline in foreign demand for U.S. exports--could be magnified by a commitment to reduce deficits. It should be noted, however, that the Balanced Budget Act does make it possible for the Congress and the President to suspend the mandated cuts temporarily if a serious slowdown is under way or if a recession is foreseen.

Uncertainties in the Fiscal Policy Outlook. Some observers doubt that the deficit targets of the Balanced Budget Act will be achieved. These doubts arise from the constitutional challenges to the act and the extraordinary magnitude of the required deficit reductions. This skepticism may be keeping long-term interest rates from falling as much as they might have. Moreover, even assuming that the deficit targets will be met, it is not yet known how this will be done. The targets could be met in part through tax increases, or by sequestration. Lack of knowledge about the likelihood, magnitude, and nature of such future policy changes can have an unsettling effect on private decisions to save and invest. Finally, deficits could be reduced by selling federal assets such as Conrail or the Bonneville Power Administration, as the Administration has proposed. But because budget transactions of this sort represent only a change in the ownership of existing assets, they do not have the same effect on aggregate demand as reductions in spending or increases in taxes.

Financial Markets and Monetary Policy

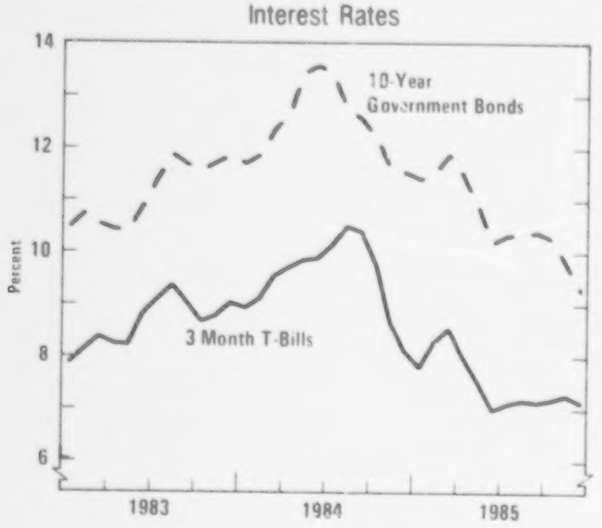
Both long- and short-term interest rates have generally been falling since mid-1984. This prolonged decline, which has left rates at levels not seen since 1980, has reflected a continuingly expansive monetary policy together with lessening credit demands that result from sluggish economic growth.

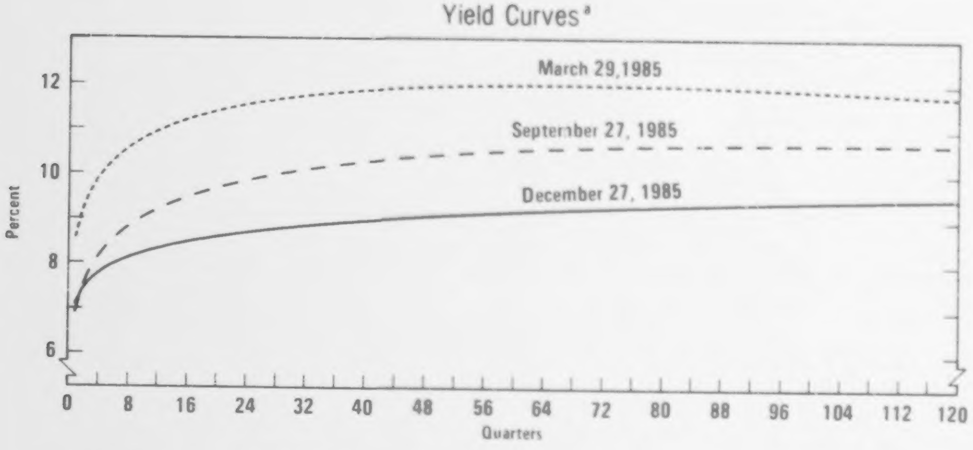
More recently, as financial markets began to reflect changes in federal deficit policy, long-term rates have dropped sharply both in absolute terms and relative to their short-term counterparts. Long-term rates fell about 100 basis points between late October and the end of 1985, while short-term rates dropped by only about 15 basis points. The sharp decline in long-term rates has significantly flattened the yield curve and, along with developments in futures markets, it suggests that market participants expect relatively flat short-term rates through the middle of 1986 at least (see Figure I-3).

Bond prices rose almost 20 percent in 1985, paralleling a significant upturn in stock prices. The Standard and Poor's 500 index rose 26.3 percent during 1985, with much of the change coming in the latter part of the year (see Figure I-4). The stock market rally has added significantly to consumers' wealth. This increase in wealth may in part be responsible for the continued underlying strength in consumer spending.

Figure I-3.

Recent Short- and Long-Term Interest Rate Movements





SOURCES: Congressional Budget Office; Federal Reserve Board.

[a] These curves were fitted to weekly average yields on Treasury instruments using a logarithmic function described by Bradley and Crane in the *Journal of Bank Research*, Spring 1973. The curves were then smoothed by hand.

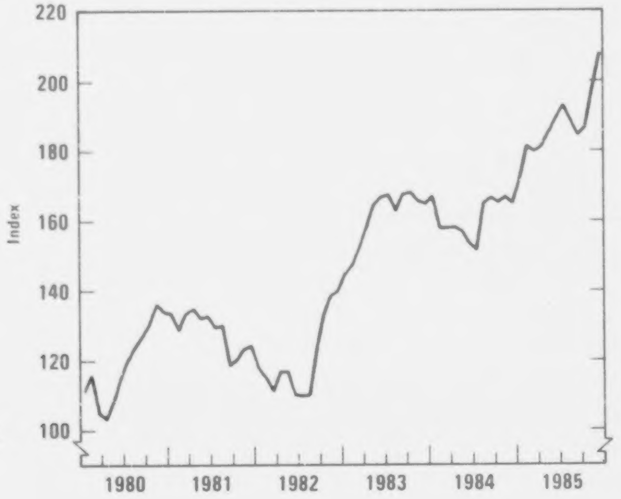
The stock and bond markets could fall sharply if it appeared that the deficit targets in the Balanced Budget Act were not likely to be met. The resulting decline in consumer wealth and the rise in long-term interest rates could place the economic expansion at risk.

Credit Demands. As shown in Table I-7, growth of nonfinancial-sector debt slowed slightly in the third quarter of 1985 (the most recent quarter for which data are available). The slowdown in corporate-sector debt occurred despite a continued surge in mergers. The growth in household debt rose slightly, reflecting continued increases in mortgage and consumer installment credit. The modest slowing in the growth of public-sector debt resulted entirely from federal operations; growth in state and local government debt rose to an annual pace of more than 26 percent.

This surge in state and local debt is not expected to continue in 1986. It appears partly to have been the result of expectations that tax legislation would be passed limiting the tax-preferred status of some state and local debt, to be effective in early 1986. (In fact, no such legislation was passed.) Although federal funding needs in the near term will remain large by historical standards, the Balanced Budget Act is expected to reduce future borrowing sharply. In addition, an expected slowing in merger-related financing should restrain the growth in corporate debt.

Monetary Policy. According to most indicators, monetary policy was expansionary during 1985, as Table I-8 and Figure I-5 show. Strong growth occurred in all of the monetary and reserve aggregates: M1, M2, M3, total

Figure I-4.
Common Stock Prices (Standard and Poor's "500")



SOURCES: Congressional Budget Office; Standard and Poor's Corporation.

reserves, and the monetary base. The only suggestion of monetary restraint came in the slight widening of the spread between the federal funds rate and the discount rate that occurred late in the year.

As measured by M1, monetary policy has been especially stimulative (Figure I-5). After growing at almost a 13 percent annual pace over the first nine months of last year, M1 fell briefly in October but resumed its rapid rise in subsequent months. This growth left M1 in December about $15 billion above the upper bound of the Federal Reserve's target range as revised in July, and $29 billion above the target range established a year ago. On the other hand, M2 and M3 grew much more modestly. After a brief surge above their target ranges in early 1985, both aggregates dropped within their ranges by mid-year, and have remained relatively on course since then. M2 is currently near its upper bound, and M3 is near the middle of its range.

More than one explanation has been offered for the differences in behavior among the money measures. One is that the declining interest-rate spreads between checkable accounts and other deposits have caused investors to shift funds from savings accounts and money market mutual funds into checkable deposits. Another widely cited explanation is that holdings of corporate demand deposits have increased in the wake of last year's check-kiting scandal as firms have tried to avoid any appearance of similar wrongdoing.

TABLE I-7. GROWTH RATES OF CREDIT MARKET DEBT, NONFINANCIAL SECTORS (Seasonally adjusted annual rates of change, in percents)

Sector	1984		1985		
	III	IV	I	II	III
Total Debt	11.5	15.2	10.7	11.8	11.4
Private	10.0	13.3	10.5	10.0	10.0
Corporate	11.6	18.2	10.9	9.0	7.1
Household	11.8	13.3	12.6	12.6	13.2
Foreign	-15.0	-0.2	-3.3	-2.5	2.4
Other	11.4	9.7	8.3	8.4	8.2
Public	15.1	19.9	11.5	16.3	14.8
Federal	15.4	19.4	10.5	15.4	11.3
State and local	14.0	21.5	14.8	19.2	26.1

SOURCE: Federal Reserve Board.

The interpretation of monetary policy has also been complicated by a mystery that affects all three of the monetary aggregates: intermittent but steep declines in velocity below its long-run trend. (Velocity is the ratio of GNP to the money stock.) While the drop in velocity is most evident with respect to M1, the M2 and M3 velocities are also low relative to their respective trends (see Figure I-6). These declines in velocity were not predicted, nor have they been successfully explained. As a result, the usefulness of the monetary aggregates in formulating or interpreting monetary policy has been at least temporarily undermined.

Previous CBO analyses have suggested that the decline in velocity in 1981-1983 may have partly reflected several factors: an increase in precautionary balances during the recession; the sharp drop in inflation and interest rates; and an increase in the interest sensitivity of M1 brought about by deregulation of interest on deposits. The more recent velocity drop in 1985 can be explained in part by a further decline in interest rates, and by an increase in transactions that require increased money balances but do not contribute to GNP: a rise in imports relative to domestic production, and an increase in transactions involving financial assets. Unfortunately, while all of these explanations have merit, quantitative studies suggest that they leave much of the decline in velocity unaccounted for.

TABLE I-8. SELECTED MONETARY POLICY MEASURES (Seasonally adjusted annual rates of change, in percents, unless otherwise noted)

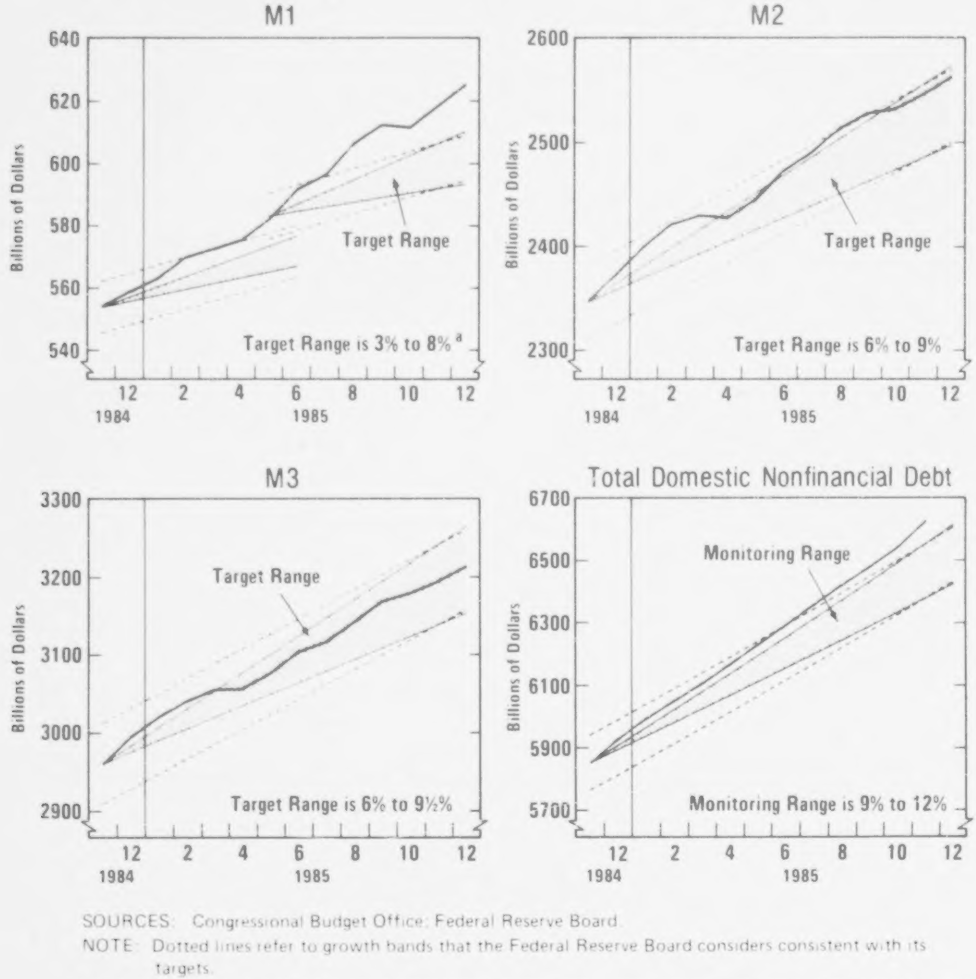
Time Period	Money Base Growth	Total Reserve Growth	Seasonal and Adjustment Borrowings (millions of dollars) a/	Federal Funds Rate-Discount Spread (percentage points) a/
1985:I	8.4	18.6	460	0.48
1985:II	7.7	12.8	593	0.15
1985:III	10.6	17.4	591	0.40
1985:IV	8.7	12.6	858	0.60
October	6.2	4.0	527	0.49
November	10.6	21.9	1,413	0.55
December	9.7	24.2	633	0.77

SOURCE: Federal Reserve Board.

a. Not seasonally adjusted.

Partly because of these issues, there have been signs that the Federal Reserve was adopting a flexible approach to its targets, especially the M1 growth range. Officials of the central bank indicated in Congressional testimony and reports that they were evaluating policy in the light of economic growth, inflation, and the exchange rate of the dollar. Tentative 1986 targets announced in July were a range of 4 percent to 7 percent for M1 growth and ranges of 6 percent to 9 percent for the growth of M2 and M3. The tentative range for the growth of total nonfinancial domestic debt

Figure I-5.
Money Growth and Targets in 1985



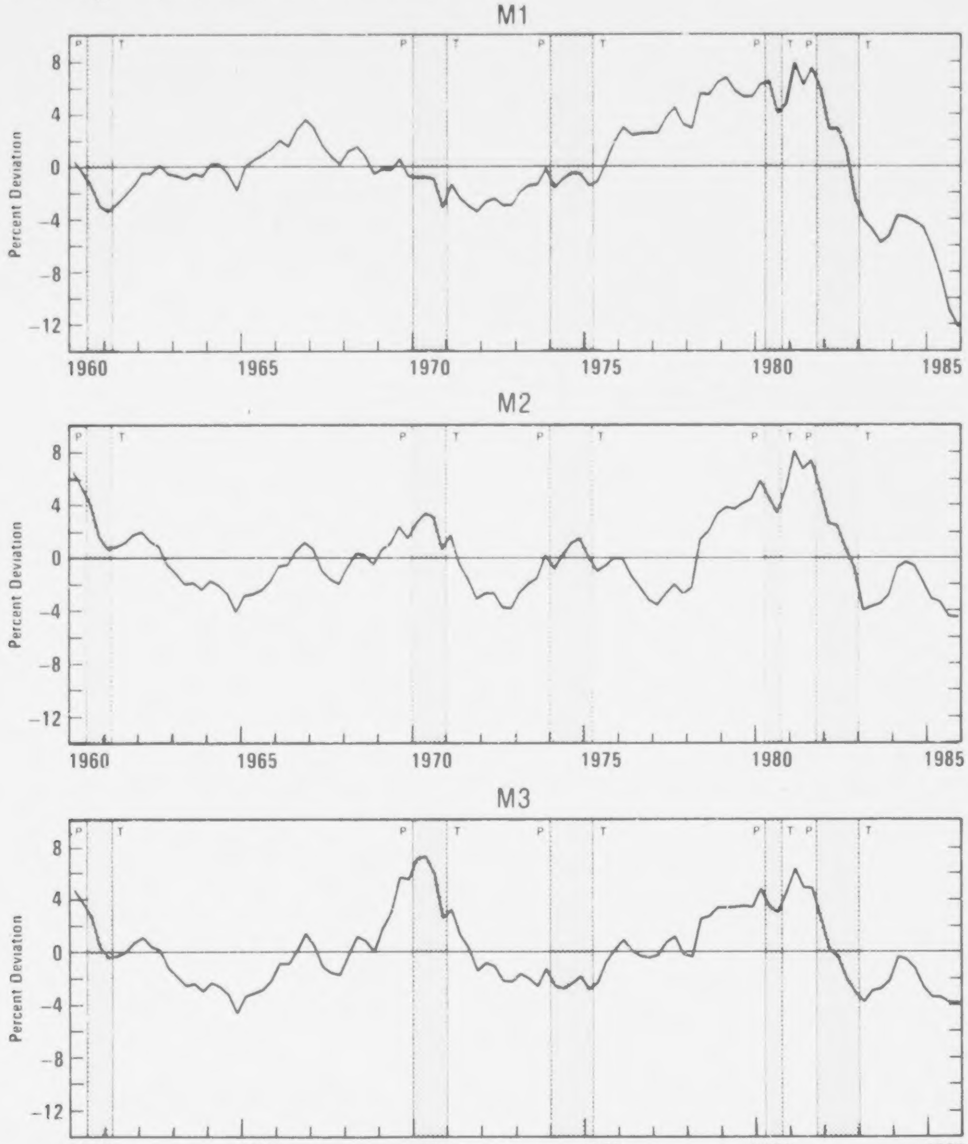
SOURCES: Congressional Budget Office; Federal Reserve Board.

NOTE: Dotted lines refer to growth bands that the Federal Reserve Board considers consistent with its targets.

[a] The initial target range for M1 was 4 percent to 7 percent; this range was widened to 3 percent to 8 percent in May and rebased.

Figure I-6.

Velocity: Deviations from Trend Level



SOURCES: Congressional Budget Office; Federal Reserve Board; U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: Velocity is the ratio of GNP to money.

was set at 8 percent to 11 percent. The official announcement of the central bank's objectives for 1986 is expected in Congressional testimony on February 19, 1986.

Stress in the Financial Markets. Despite falling interest rates in 1985, failures among thrift institutions continued, and the year saw a record number of bank failures. Crises in Ohio and Maryland served to highlight the vulnerability of state- and privately-insured institutions compared with those covered by federal deposit insurance. Although the decline in long-term interest rates has dramatically improved the net worth of thrift institutions, they remain very sensitive to interest-rate movements. Moreover, many are still plagued by poor assets in their portfolios. Even the Federal Savings and Loan Insurance Corporation, the government insurer, has been beset by net worth problems and has suggested a recapitalization scheme to the Congress.

Weakening energy and agricultural prices have caused problems for many banks with loans to these sectors, and for the Farm Credit System. About 40 percent of the banks on the FDIC's "watch list" are agricultural banks. Recent legislation has attempted to ensure a continued flow of credit to the troubled farm sector, but a rise in interest rates would make the rescue plan more costly.

Finally, many banks are burdened by loans to some third-world countries whose deteriorating trade balances make them less able to service their debts. The Administration's concern over this problem resulted in the so-called "Baker initiative," which calls for increased commercial bank and official development loans ($20 billion from the commercial banks and $9 billion from development banks) to major third-world debtor countries in exchange for their promises of internal reforms designed to promote long-term economic growth.

RECENT ECONOMIC DEVELOPMENTS

Economic expansion slowed in 1985 from its strong pace of the previous year. Employment grew strongly, however, and inflation seemed to subside. Oil prices, the exchange rate, and long-term interest rates fell sharply. These developments, together with evidence of a pickup in economic activity late in 1985, appear to signal improved prospects for growth in coming months.

Aggregate Economic Activity

Real GNP growth was 2.3 percent during 1985, down sharply from the 6.6 percent pace of the previous year (see Table I-9). Industrial production grew only 2.2 percent in 1985 compared with 11.6 percent the previous year.

Capacity utilization was essentially unchanged. Final sales and real final sales to domestic purchasers both grew more strongly than did GNP, reflecting the fact that businesses were reducing their inventory/sales ratios and the fact that the balance-of-trade deficit was continuing to grow, channeling domestic purchasing power to foreign producers.

Employment grew quite strongly over the course of 1985 and the first weeks of 1986, reducing the unemployment rate to 6.7 percent in January of this year, its lowest level since March 1980. The strong growth in employment was, however, a reflection of disappointing productivity growth in 1985.

TABLE I-9. REAL GNP AND INDUSTRIAL PRODUCTION
(Percent change from previous period at annual rates, unless otherwise noted)

Economic Indicator	1984	1985	1985 I	1985 II	1985 III	1985 IV
Real GNP	6.6	2.3	3.7	1.1	3.0	2.4
Final sales	4.5	4.0	6.2	1.2	5.0	2.1
Personal consumption	4.4	3.2	4.8	2.6	4.6	-0.2
Business fixed investment	19.5	9.6	-0.5	12.5	2.4	10.3
Residential investment	13.2	1.9	1.7	7.1	8.5	8.6
Government purchases	4.3	5.8	-1.4	4.7	18.2	7.0
Exports	6.2	-2.9	-8.8	-10.9	-5.1	8.0
Imports	22.8	2.1	-27.6	18.2	12.8	13.0
Inventory Change (billions of 1982 dollars)	62.7	7.3	15.8	15.1	-1.8	0.1
Net Exports (billions of 1982 dollars)	-85.0	-105.1	-71.8	-101.1	-119.8	-127.6
Real Final Sales to Domestic Purchasers a/	6.4	4.5	2.7	4.5	7.0	2.9
Industrial Production	11.5	2.2	2.3	1.3	1.9	1.3
Consumer durables	14.2	0.2	1.4	-4.2	3.3	4.0
Business equipment	16.9	4.7	3.2	3.8	2.0	-2.2
Defense and space	10.4	10.0	8.0	10.9	9.7	12.1

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board.

a. Real final sales minus net exports.

Late in the year, several short-term indicators showed signs of a speedup in GNP growth. Retail sales and housing starts rose sharply in December, and oil prices fell sharply both in December and again after the turn of the year. Employment continued its strong growth during the fourth quarter. All these factors increase the likelihood that economic expansion may speed up somewhat in 1986.

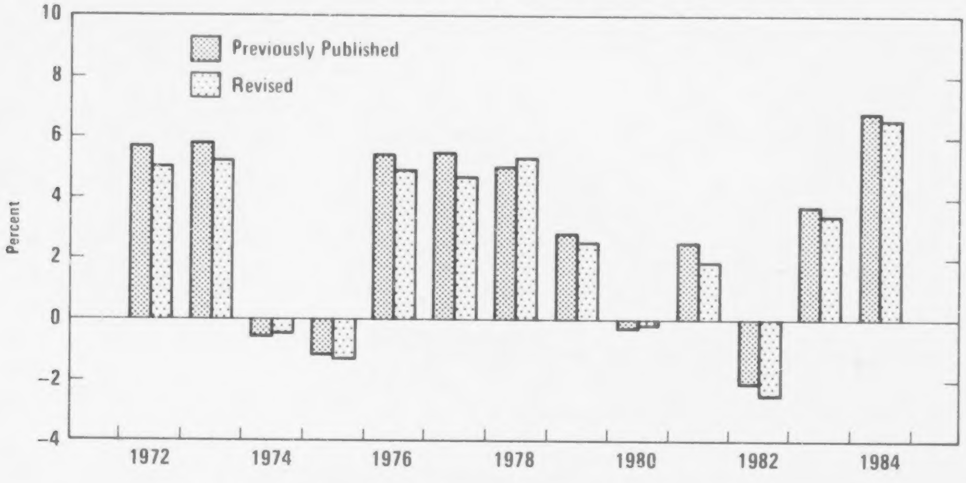
In December, the Commerce Department released major benchmark revisions of the national income accounts (see Box I-1). Periodic revisions are needed to incorporate improved estimating procedures and new information (such as new evidence on the size of the "underground" economy) that had previously been excluded from the official accounts. Analysis of how the revisions change the picture of the economy's performance since the early 1970s is only just beginning. Some of the major effects in particular sectors are described later in this chapter.

Labor Markets

Labor markets strengthened considerably last year. Nevertheless, unemployment remained high in 1985, particularly among blacks. Wage increases were moderate, and productivity growth slowed.

Figure I-7.

Real GNP Growth Rates: Before and After Benchmark Revisions



SOURCES: Congressional Budget Office; U.S. Department of Commerce, Bureau of Economic Analysis.

BOX I-1

REVISING THE NATIONAL INCOME ACCOUNTS

The Commerce Department's recent release of revised National Income and Product Account (NIPA) estimates contains a number of significant changes, even though the nominal GNP growth rates are essentially the same as shown by the old data. The revisions incorporate new data sources, better estimating methods, changes in definitions, and the rebasing of price indexes from 1972 to 1982.

In rebasing, the prices of 1982 rather than those of 1972 are used as the basis for calculating the constant dollar series, and the composition of output in 1982 is used for calculating fixed-weighted price indexes. This makes the new NIPA figures more relevant for measuring recent changes in real output and prices.

Virtually all NIPA data are collected in current dollar terms. To measure changes in real (constant dollar) values, the nominal data are "deflated" by the price index. Because rebasing can dramatically change the relative levels of the price indexes, relationships among the constant dollar series for different items in the accounts can be affected by the rebasing. For example, before the revision the price deflator for personal consumption expenditures for gasoline and oil was 356 in 1982, and the deflator for autos and parts was 191. Dividing the nominal data for these categories of spending by their respective deflators resulted in estimates of real (1972 dollars) expenditures of $25.0 billion on gasoline and oil and $57.0 billion on autos and parts. With rebasing, the price indexes for all categories are set to 100 in 1982. The nominal values are not generally changed as part of the rebasing process, so the same nominal values are divided by the new indexes. This results in a real (1982 dollars) value for autos of $108.9 billion in 1982, and for gasoline and oil of $89.1 billion. Whereas the previous data would lead one to believe that real expenditures on autos and parts in 1982 were more than two times those on gasoline and oil, the revised data indicate that gasoline and oil expenditures consumed almost the same percentage of consumers' dollars as did spending on autos and parts.

Unemployment. The civilian unemployment rate stayed at about 7¼ percent during the first three quarters of 1985 before edging down to an average of 7.0 percent in the last quarter and to 6.7 percent in January 1986. Among demographic groups, jobless rates continued to be slightly lower for men than for women (in the recession, the opposite had been true). The unemployment rate continued at about 15 percent for black workers and 6 percent for white workers--roughly the same as in 1984 (see Table I-10). Black teenagers continued to suffer by far the highest unemployment of any

The increased "weighting" of the GNP components that have risen more in price since 1972, shown by this example, is a general characteristic of rebasing. It leads to downward revisions in year-to-year real growth rates because, in general, the growth in demand (and consequently the growth in levels of production) for goods that increase more in price will be slower than for goods that have lower rates of inflation. By increasing the weighting of these very categories of goods, rebasing causes the measured growth of real output to be revised downward. Comparisons of previously published and revised data on real values are confused by this aspect of rebasing. The revised data do, however, provide a more accurate reflection of recent year-to-year changes in real economic activity than do the previously published figures.

The average annual growth rate of nominal GNP for the 1972-1984 period was not changed by the revision, remaining at 9.9 percent. The average growth of real GNP for that period, however, was revised down from 2.7 percent to 2.5 percent (see Figure I-7). When the effects of rebasing on the measured growth rate are removed by using 1972 weights, however, the revision actually raises the average real GNP growth rate for the 1972-1984 period to 2.9 percent.

The major factors contributing to the upward revision of real growth when the rebasing effect is eliminated are the use of a new deflator for computers, improved adjustments for unreported income (which affects estimates of both the income and product components of GNP), and revisions in residential investment. The sharp downward revision in the growth rate of the deflator for computers translates into higher real growth rates for durable equipment, exports, and federal purchases of goods and services. The use of the new deflator for computers is also a major reason for a downward revision in the rate of inflation as expressed by the fixed-weight GNP price index.

The GNP shares of two income categories were radically changed by the revision. Proprietors' income was revised upward by about 2 percent of GNP because of the new estimates of misreported income and the rental income share fell from 1.5 percent to 0.2 percent of GNP. These new estimates are a major reason for a general upward shift in the saving rate of about half a percentage point. In spite of the upward shift, the historical pattern of the movements in the saving rate, including its recent decline, was not changed by the revision.

major group: at approximately 40 percent, their unemployment rate was about the same as in 1984, though somewhat lower than the level of nearly 50 percent that it had reached in 1983, just after the end of the last recession.

The labor market showed signs of strength during the last months of 1985, as Table I-10 indicates, and in January as well. Unemployment fell one-tenth of a percent in November and in December, and another two-

TABLE I-10. EMPLOYMENT AND UNEMPLOYMENT (Percent change from previous period at annual rates, unless otherwise noted)

				1984				1985			
	1983	1984	1985	I	II	III	IV	I	II	III	IV
Payroll Employment											
Nonfarm	0.7	4.7	3.4	5.5	4.3	3.9	4.0	3.3	2.9	2.6	3.5
Goods-producing	-2.0	6.0	1.3	8.0	4.6	3.0	1.8	1.7	-0.3	-1.1	1.8
Service-producing	1.7	4.3	4.2	4.6	4.1	4.2	4.8	3.9	4.1	3.9	4.1
Civilian Employment	1.3	4.1	2.0	4.2	5.3	1.3	2.3	2.5	0.7	1.5	3.0
Civilian Unemployment											
Rate (percent)	9.6	7.5	7.2	7.9	7.5	7.4	7.2	7.3	7.3	7.2	7.0
Adult males	8.9	6.6	6.2	7.0	6.6	6.5	6.2	6.3	6.3	6.1	6.0
Adult females	8.1	6.8	6.6	7.0	6.7	6.8	6.7	6.7	6.8	6.7	6.4
Whites	8.4	6.5	6.2	6.8	6.5	6.4	6.2	6.3	6.3	6.2	6.0
Blacks	19.5	15.9	15.1	16.7	16.0	15.8	15.1	15.5	15.0	14.8	15.1
Teenagers	22.4	18.9	18.6	19.6	18.9	18.7	18.3	18.5	18.3	18.3	19.0
Black teenagers	48.4	42.7	40.1	45.4	42.4	42.2	41.0	41.7	39.7	38.4	40.7
Employment-to-Population											
Ratio (percent)	57.9	59.5	60.1	59.0	59.6	59.7	59.8	60.0	60.0	60.1	60.3

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

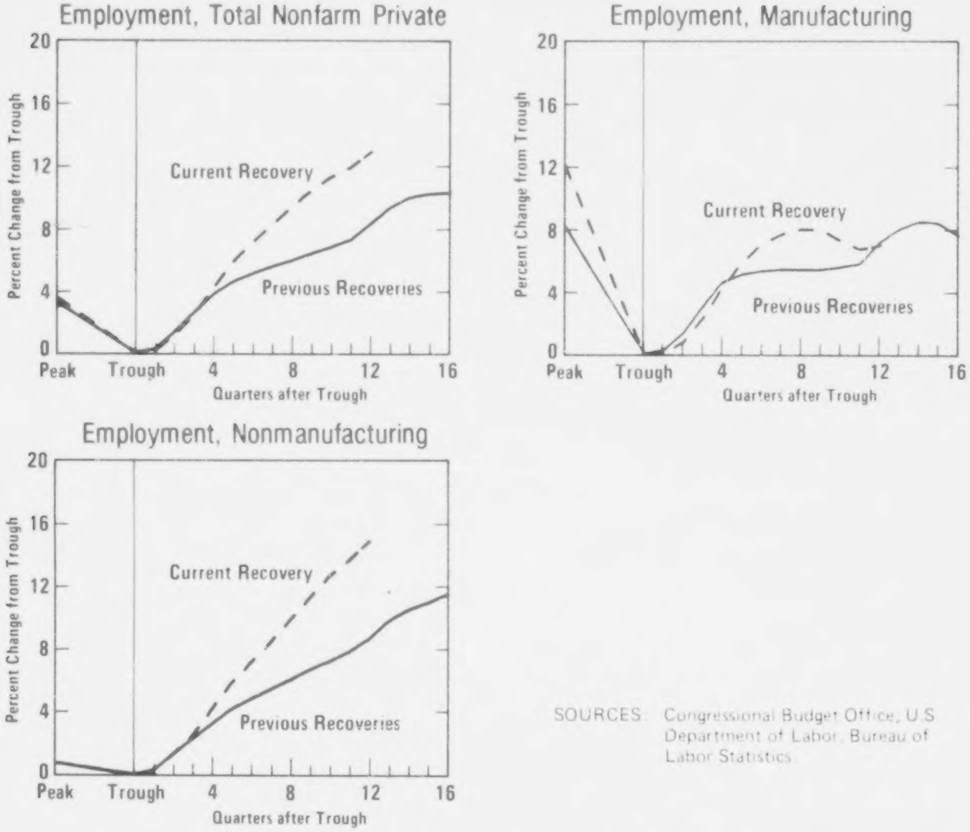
NOTE: Nonfarm payroll employment is measured by a survey of business establishments. The civilian employment and unemployment rates cited are based on a survey of households.

tenths in January; the ratio of employment to population reached a new high. Nonfarm payroll employment grew strongly in December and January. Employment in the goods-producing sector, which had been stagnant during the second and third quarters, grew at a 1.8 percent annual rate in the last quarter. (By contrast, service employment grew steadily throughout the year at a 4 percent rate.) Modest employment gains were widespread across industries. In December and January, about two-thirds of all industries were reporting employment gains. The average workweek in manufacturing--a barometer of changes in labor demand--rose to 41.0 hours in December from 40.7 in November. Overtime hours in manufacturing also edged up to 3.6 per week from 3.4 in November.

Employment growth in this recovery has been considerably stronger than for the average recovery in the postwar period (see Figure I-8). The

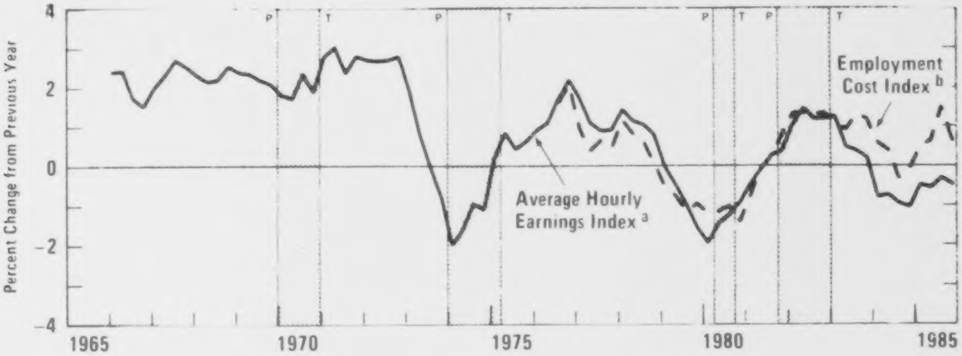
Figure I-8.

Cyclical Comparisons of Employment Growth



SOURCES: Congressional Budget Office; U.S. Department of Labor, Bureau of Labor Statistics.

Figure I-9.
Real Wages



SOURCES: Congressional Budget Office; U.S. Department of Labor, Bureau of Labor Statistics.

NOTE: The Employment Cost Index begins in the mid-1970s.

[a] Average hourly earnings index for nonfarm private industry, deflated by the fixed-weight personal consumption price index.

[b] Employment cost index for wages in the nonfarm private economy, deflated by the fixed-weight personal consumption price index.

unusually rapid growth has been concentrated in the nonmanufacturing sector; employment growth in manufacturing has been about average.

Wages. Gains in wages were moderate in 1985, reflecting continued high unemployment and subdued inflation. At more than 7 percent, the unemployment rate was substantially above the roughly 6 percent rate at which many analysts expect labor markets to become a source of inflationary pressures. 8/

Finally, small increases in food and fuel prices contributed to the moderation of wage increases. As shown in Figure I-9, gains in real wages have been unusually low, and according to one measure they have been negative.

Collective bargaining settlements in general showed extremely low wage gains in 1985. Major bargaining contracts provided average wage adjustments of 2.3 percent in the first year and 2.7 percent annually over the life of the contract (not including all potential increases from cost-of-

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8. This level is often estimated at between 6 percent and 6.5 percent, which is higher than it was in the 1950s and 1960s in part because women and young workers, who now form a larger part of the labor force, tend to have to spend a larger proportion of their time in job searches than do adult males, more of whom have settled jobs. As the baby boom bulge of people entering the labor force slows down, the level of unemployment consistent with constant inflation is likely to be lower.

living provisions). The last time the same parties bargained (generally two to three years ago), average adjustments were 3.9 percent the first year and 3.7 percent a year over the contract life. Contrary to experience before the 1980s, many contracts were "back-loaded"--that is, they had lower wage adjustments in the first year than in subsequent years.

As shown in Table I-11, the Employment Cost Index grew at a 4 percent to 5 percent rate during 1985, moderately less than in 1984. For the year ending in December 1985, compensation cost increases were almost one percentage point below those of a year earlier (4.3 percent versus 5.2 percent). A deceleration in employee benefit costs was largely responsible for the slowdown in compensation cost increases. The aggregate index masked divergent trends, however. Reflecting differences in labor-market conditions, growth in compensation was faster for workers in service-producing industries than for those in the goods-producing industries and faster for nonunion than for union workers. By occupational groups, the gains of service workers and white-collar workers outstripped those of blue-collar workers.

Productivity. Increases in output per worker hour slowed dramatically in 1985. In 1983 and the first half of 1984, gains in productivity had been quite rapid, though about average for an early recovery period. As the economic expansion slowed, however, productivity growth in the nonfarm business sector disappeared. Productivity growth in manufacturing also slowed sharply in 1985, but it continued at a faster pace than for the nonfarm sector as a whole. During the three years since the beginning of recovery, productivity growth in the nonfarm business sector as a whole was about average for the first six quarters, but it has been far below average for the next six (Figure I-10). Productivity growth in manufacturing appears slightly better than average, but the productivity performance in the rest of the nonfarm business sector appears very poor. It should be noted, however, that data on recent productivity trends in this sector, and to a lesser extent in manufacturing, are subject to wide margins of error.

Inflation

Inflation has not increased in the three years since the last recession, in contrast to the pattern in most postwar recoveries. Recently many commodity prices have grown weakly or have actually fallen. Wages, a source of inflationary pressure in the past, have shown only moderate gains. As a result, inflation in 1985 was somewhat less than that in 1984, as reflected in the fixed-weight GNP deflator (a broad measure of prices for goods and services produced in the United States) and the Consumer Price

TABLE I-11. COMPENSATION, PRODUCTIVITY, AND UNIT LABOR COSTS
(Percent change from previous year or from four quarters ago)

	1983	1984	1985	1984				1985			
				I	II	III	IV	I	II	III	IV
Hourly Earnings Index	4.6	3.4	3.0	3.6	3.5	3.4	3.1	3.1	3.1	2.9	3.0
Employment Cost Index	6.1	5.4	4.6	5.8	5.5	5.1	5.2	4.8	4.6	4.9	4.3
Union workers	6.7	4.6	3.1	5.3	4.9	4.1	4.3	3.5	3.1	3.2	2.6
Nonunion workers	5.7	5.5	4.9	5.8	5.7	5.2	5.2	4.9	4.9	5.4	4.6
Goods-producing industries	5.4	4.6	4.0	4.7	4.6	4.4	4.7	4.6	4.2	4.0	3.4
Manufacturing industries	5.6	4.9	4.3	4.8	4.9	4.7	5.2	5.1	4.6	4.2	3.3
Service-producing industries	6.5	6.0	5.0	6.5	6.3	5.5	5.6	4.9	4.8	5.5	4.8
Blue-collar workers	5.5	4.4	3.7	4.8	4.4	4.2	4.4	3.8	3.8	4.0	3.3
White-collar workers	6.5	5.9	5.2	6.3	6.3	5.4	5.6	5.3	5.1	5.4	4.9
Service workers	6.0	6.5	4.6	6.7	6.1	6.8	6.5	4.8	4.8	5.1	3.9
Compensation per Hour a/	4.7	3.7	3.7	3.5	3.6	4.0	3.8	3.7	3.8	3.6	3.7
Output per Hour a/	3.4	1.6	0.0	2.6	1.7	1.2	0.8	0.2	-0.3	0.1	-0.1
Unit Labor Cost a/, b/	1.3	2.0	3.7	0.9	1.8	2.7	2.9	3.5	4.1	3.5	3.8

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

a. Nonfarm business sector.

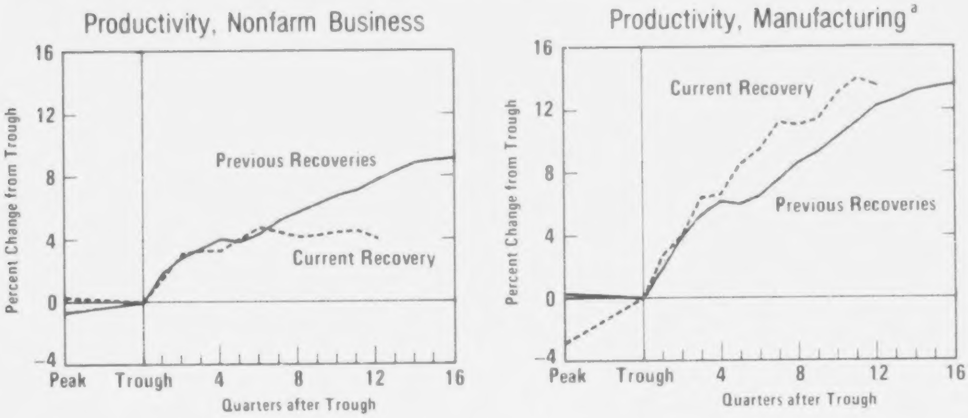
b. The index of unit labor cost is calculated by dividing the index of compensation per hour by the index of output per hour.

Index (a measure of prices paid by consumers that includes prices of imported goods). Excluding changes in prices of food and energy, inflation in final-goods prices has risen moderately in the past two years (see Table I-12).

The rate of inflation was lower on average in the last half of 1985 than had been expected--the result of falling prices of food, energy, and used cars. Some prices began to increase more rapidly in recent months, but mostly for special reasons that are not expected to persist. Thus, meat prices were low for most of the year because of temporary increases in slaughter rates that are now coming to an end. On average, however, the price of food purchased by consumers to eat at home increased by only 2.1 percent over the 12 months of 1985. Oil prices also increased temporarily in

Figure I-10.

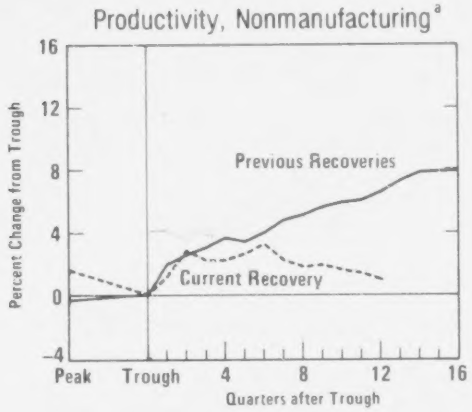
Cyclical Comparisons of Productivity Growth



Productivity, Nonfarm Business

Productivity, Manufacturing[a]

Productivity, Nonmanufacturing[a]



SOURCES: Congressional Budget Office; U.S. Department of Labor, Bureau of Labor Statistics.

[a] Productivity measures for manufacturing and nonmanufacturing in the last four quarters are subject to large revisions. Nonmanufacturing productivity, which is based on unpublished data, is especially uncertain for those quarters.

the fall, the result of low oil inventories at the beginning of the heating season in the United States and Europe. As a result, the CPI increased somewhat faster during the last three months of the year than it had from May through September. (The sharp oil price declines late in December occurred too late to affect 1985 inflation significantly.)

The outlook for inflation in the next year is highly uncertain. Some developments could lead to much lower inflation:

o Oil prices have fallen dramatically in recent weeks and in early February were about 46 percent below what they were in November. In coming months, these declines could significantly reduce the growth of the CPI, and, to a lesser extent, that of the GNP deflator.

TABLE I-12. INFLATION (Percent change, fourth quarter to fourth quarter)

Price Measure	1980	1981	1982	1983	1984	1985
Fixed-Weight GNP Deflator	9.8	8.5	5.0	3.8	4.2	3.5
CPI for All Urban Consumers a/	10.9	8.8	5.3	3.6	4.1	3.5
Stripped CPI b/	9.4	8.6	6.2	4.1	4.5	4.7
PPI Finished Goods	12.3	7.2	3.5	0.8	1.7	1.6
PPI Crude Materials	14.2	-2.6	-0.8	4.3	-1.1	-5.9
PPI Crude Oil	33.5	30.2	-7.3	-7.5	-2.5	-5.7
PPI Refined Petroleum Products	28.2	13.6	-6.0	-9.3	-4.6	-2.0
CPI for Food at Home	10.7	3.7	2.5	1.4	3.8	1.4
CPI for Energy	18.9	12.6	1.9	-1.7	0.3	0.9

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

a. The Consumer Price Index (CPI) is published in two versions: the CPI-U for all urban consumers, shown here, and the CPI-W for urban wage and clerical workers, shown in the projections in Table I-3. Before 1983, both measures used a flawed measure of the cost of homeownership; this was corrected in 1983 for the CPI-U, reported here, and in 1985 for the CPI-W. The CPI growth rates for 1980-1982 reported here are those of an experimental CPI measure that approximates the current CPI treatment of homeownership.

b. CPI less food at home, energy, and used cars.

- Other commodity prices, especially for agricultural commodities, remain weak, and prices for some crops are expected to fall this year.

- Wage gains have been moderate, as explained earlier.

Other important developments, however, point to a possible increase in the inflation rate:

- The money supply (M1) has increased at an average annual rate of about 9 percent over the past two years, as the discussion above points out. The possible delayed effects of this growth could lead to inflationary pressures in labor markets and other sectors next year. While unemployment is currently not at inflation-generating levels, it has been moving down, and should a strong delayed effect from last year's monetary growth materialize, it could put it in the danger zone.

- The exchange rate of the dollar has depreciated 16 percent over the past year and is expected to continue falling.

In combination, these factors make the inflation forecast unusually uncertain.

Special Factors Holding Down Inflation. The massive appreciation of the dollar from early 1980 to early 1985 played a large role in reducing inflation rates. Most estimates suggest that as the dollar appreciated by 60 percent to 85 percent, it reduced annual inflation rates (measured by consumer prices) by between one and two percentage points.

The dollar reached its peak in early 1985, then fell about 21 percent and finished the year about 16 percent below its value in December 1984. This development should eventually put upward pressure on prices in the United States. The timing and magnitude of this effect are difficult to predict, however. This is because the recent declines in the dollar's international value may have been partly absorbed in changes in the profit margins of foreign exporters, as well as of importers and distributors in the United States, rather than being passed through to ultimate purchasers. Some markets where imports have a dominant market share, such as consumer electronics and semiconductors, have already experienced price rises. The falling dollar is likely to begin soon to put upward pressure on prices of domestically produced goods and services as well.

Falling oil prices have also contributed to the decline in inflation (see Figure I-11). The downward drift of oil prices since 1980 has come about in part because of the conservation measures precipitated by the oil price

BOX I-2

THE OIL PRICE COLLAPSE

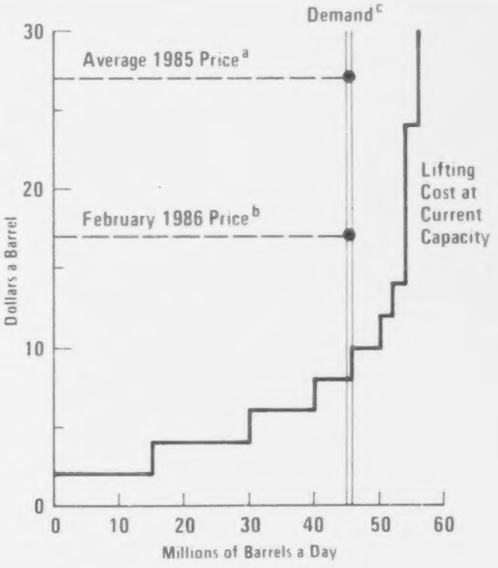
Since November 1985, crude oil prices have plummeted from over $28 a barrel to below $17 a barrel as of the first week of February 1986. Prices remain extremely volatile, and neither a resurgence nor a further decline can be ruled out. At $17 a barrel, oil prices in real terms are about 25 percent below their average level in 1974, immediately following the first large price increase by OPEC, but about three times their level in early 1973. At its peak in 1981, the real price of oil was nearly seven times its early 1973 level.

The immediate cause of the collapse in oil prices was a decision by Saudi Arabia to increase its share of the world oil market by raising production levels. This represents a reversal of its longstanding policy of stabilizing prices by restricting output, a policy that had forced it to reduce output by almost 80 percent between 1981 and 1985. In summer 1985, Saudi oil output fell to a low of 2.2 million barrels a day (mmbd), about half of its OPEC quota. The Saudis had borne the brunt of OPEC's effort to defend prices in the face of growing world oil production and stagnant world demand. The recent increase in Saudi Arabian output by at least 2 mmbd, combined with higher output from several other members of OPEC, has raised total OPEC crude oil output from a low of around 14 mmbd to at least 18 mmbd over the last six months. With non-OPEC supply remaining constant, the current supply of crude oil to free-world consumers is about 47-49 mmbd, which is about 2-3 mmbd in excess of current use. This excess supply has caused prices to fall. Since demand responds only weakly to oil price changes over the short run, a severe drop in price is required to induce enough of an increase in quantity demanded to clear the market. Given current production plans, this could mean market clearing prices in the $12 to $16 range. (This calculation uses standard estimates of short-run demand responsiveness to price changes. A decline in price to about $14 a barrel would force only about 1 mmbd of production to be shut down worldwide in the short run.) It is impossible, though, to predict how producers with excess capacity might respond to such lower prices. Considering that almost all the world's excess capacity is concentrated in the lowest-cost OPEC producers, almost half of it in Saudi Arabia, if OPEC decided to produce at full capacity, prices could fall to as low as $8 to $10 a barrel in the short run. In the long run, shifts in supply and demand for oil would probably cause these prices to rise substantially.

Whether prices actually go that low will depend on whether producers try to organize again, as OPEC first did in the early 1970s.

Indeed, the approach of producers--both OPEC and non-OPEC--to coordinating output levels is the major uncertainty for the oil market in the near term. A key concern influencing any prospective agreement among producers is how revenue from oil sales is affected by various combinations of output and price. Using a plausible scenario, oil prices might stabilize at $15 a barrel when OPEC members produce 19 mmbd, or at $25 a barrel if they produce 14 mmbd. At 19 mmbd, their annual revenues would be about $104 billion compared to around $128 billion at 14 mmbd. In this example, OPEC collectively gains from higher prices; in the short run, however, individual OPEC members might have different interests. For Saudi Arabia, production of 5 mmbd at $15 a barrel yields about $27 billion annual sales, while 2.5 mmbd priced at $25 a barrel brings in only $23 billion. In this case, at least in the short term, Saudi Arabia loses with higher prices. Given Saudi unwillingness to incur further revenue losses in order to support higher prices, oil prices are likely to remain well below their 1985 levels unless other producers agree to limit output in a manner deemed equitable by Saudi Arabia. To put any such decision in perspective, eliminating the current excess output of 2-3 mmbd would involve an across-the-board reduction of only about 7 percent to 10 percent from current production levels on the part of OPEC and major non-OPEC oil exporters.

Lifting Cost of Crude Oil



SOURCES: Congressional Budget Office; Texas Eastern Corporation; Exxon Corporation.

[a] OPEC output in 1985 averaged 16 million barrels a day.

[b] OPEC output in early 1986 was about 18.5 million barrels a day.

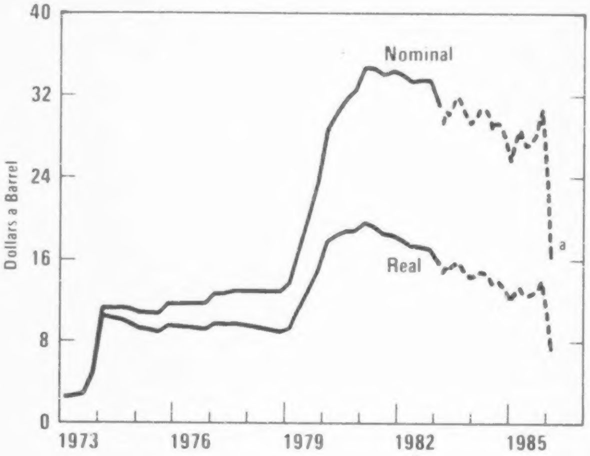
[c] Free world consumption in 1985 and the rate of consumption estimated for early 1986 are approximately 45-46 million barrels a day (consumption does not change much in response to price changes in the very short run).

increases of 1974 and 1979, and partly from strong growth in world supply. Since the trough of the past recession in the fourth quarter of 1982, oil consumption in the United States has increased only 4 percent, while real GNP has increased 14.1 percent. Because oil is priced in dollars, until the recent dollar depreciation it grew more expensive relative to other goods in many countries whose currencies are not tied to the dollar, encouraging even more conservation abroad.

The downward pressure on oil prices has recently been increased by a change in OPEC's policies (see Box I-2). OPEC has had to face growing production from countries outside its membership. It stemmed price declines for a while by cutting its own production, with a large proportion of the cuts made by Saudi Arabia. Recently, Saudi Arabia has indicated that it would seek to increase its market share even at the cost of a sharp price reduction. Prices fell dramatically in the New York market in response to this announcement; at one point in February, the price of oil for delivery in March was below $16.00, down from about $28.50 in November.

Another factor in the decline of inflation has been the weakness in prices of agricultural products and of some other major internationally traded commodities. The downward pressure on these prices has stemmed partly from the dollar's appreciation, but has been magnified by increases in production that are not directly related to demand increases. Some

Figure I-11.
Nominal and Real Oil Prices



SOURCES: Congressional Budget Office; U.S. Department of Commerce, Bureau of Economic Analysis; Central Intelligence Agency, Directorate of Intelligence; New York Mercantile Exchange.

NOTE: The nominal price series is the official OPEC price (quarterly data) until 1983:1. The N.Y. Mercantile Exchange forward price for oil to be delivered in the next month is used thereafter. The real price series is the nominal price divided by the fixed-weight GNP price index.

[a] Average forward price in the first week of February for oil to be delivered in March.

examples are big harvests in the United States and elsewhere, the increasing self-sufficiency of developing countries in food, and increases in raw-material production that are part of the long-term development plans of some poorer countries.

The farm support system in this country has partly offset the farm income losses that normally would accompany commodity price declines, but at the cost of lower exports and a large increase in the federal deficit (see Box I-3). (The European Community has a similar farm support policy, but sells its excess production on the world market rather than holding it in stockpiles. This contributes to the U.S. farm problem.) The Food Security Act of 1985 reduces support prices for farm products in order to stimulate exports. World prices of farm products are thus likely to drop further, which should help to keep inflation down in 1986.

Closely related to the weakness of the dollar and of commodity prices is the relative sluggishness of domestic demand in other advanced countries, as compared with that in the United States. Japan's domestic demand growth since the U.S. recession trough has been only about half as strong as that of the United States, while demand in major European countries has grown even less strongly. In part, this discrepancy is the result of restrictive monetary and fiscal policies in many countries. These policies were undertaken to confront the same problem of high inflation that the United States faced, and to counteract depreciation of some currencies. The effect of these policies has been to keep the growth of demand in the rest of the industrial world well below that of the United States. This, in turn, has moderated inflation throughout the developed world and held down prices of traded goods.

Underlying Determinants of Inflation. Among the fundamental domestic determinants of inflation are the rates of unemployment and capacity utilization, and monetary policy. Because the last recession was very deep, the economy has not yet returned to levels of employment and capacity utilization typical at this stage of a business cycle. The unemployment rate remains above the level that presages an increase in the rate of inflation. Moreover, the estimated "noninflationary" unemployment rate is likely to move down over the next few years as the members of the large recent bulge of new entrants to the labor force advance in their careers. Capacity utilization in manufacturing, at 80.3 percent in December 1985, was about three percentage points below the rate at which inflation has accelerated in the past.

A period of sustained rapid growth in the money supply, such as experienced recently, would traditionally have been seen as a harbinger of

BOX I-3

THE PLIGHT OF THE AGRICULTURAL SECTOR

Farming in the United States is now closely linked to economic conditions abroad. During the 1970s, world demand for farm commodities outstripped foreign production, pushing up prices, profits, and land values in the United States. But in the 1980s the picture changed. Counterinflationary economic policies in many countries resulted in lower economic growth, dampening world demand for agricultural products. At the same time, farm production abroad was stimulated by favorable price movements, government subsidies, and improved technologies. Rising supply and flagging demand have exerted downward pressure on prices, causing U.S. farm exports to fall sharply over the last year.

Farm production in the United States remains modestly profitable, even though the total return on average farm equity, inclusive of imputed capital losses caused by falling land values, has turned negative. Increases in production and government income and price supports have significantly offset the effect of lower prices on farm incomes. Nevertheless, some heavily-indebted farmers are faced with severe financial hardship because they must pay back debt incurred when prices were high with income generated when prices are much lower. Many farmers have progressively reduced their debt service burden, aided by lower interest rates, and are limiting future debt accumulation by cutting back on new machinery and land purchases.

World demand for U.S. agricultural output is likely to increase in the future if the dollar continues to depreciate and U.S. farm support prices fall. Still, foreign supply capacity and prospects of only moderate foreign income growth will force the U.S. farm sector to continue retrenching until it returns to operating conditions more closely resembling the 1960s than the 1970s.

The Farm Security Act of 1985 is designed to facilitate this adjustment. It provides incentives to reduce farm production by tying acreage reduction requirements to eligibility for price and income support programs and by introducing a program to discourage farming of highly erodible land. Also included are provisions that reduce price support levels (loan rates) in an effort to stimulate demand, while maintaining income support levels (target prices for deficiency payments) in order to moderate declines in farm income.

increased inflation. For much of the 1980s, however, the relationship between money and the economy has been so volatile as to make it difficult to make such forecasts with confidence, as the discussion earlier in this chapter showed. The ratio of GNP to the money supply--referred to by economists as monetary velocity--has fallen drastically for reasons that are not well understood. Because of this decline, the Federal Reserve has been able to increase the growth of M1 without an increase in inflation. CBO assumes in its forecast that if velocity starts to increase rapidly, the Federal Reserve will offset the increase with slower money growth.

The Outlook for Inflation. Most current forecasts show inflation rising marginally from 3.5 percent in 1985 (as measured by the CPI) to the 3.5 to 5.0 percent range in the 1986-1987 period. This outlook embraces a number of offsetting factors, and is therefore subject to great uncertainty. On the one hand, a declining dollar could give inflation an upward push over the next year. This might be reinforced by continued rapid money growth, if it was not offset by velocity changes. On the other hand, a continuing decline in the international price of oil and weakness in other commodity prices (especially food) would work to reduce inflation, as would a continuation of the recent steadiness in real wages.

Consumption

In 1985, personal consumption expenditures grew 3.2 percent after inflation, faster than both GNP and disposable income. This growth is reflected in a drop in the personal saving rate, various measures of which are shown in Figure I-12. 9/ A relatively low saving rate is not unusual during periods of recession or sluggish growth; at such times, people try to maintain relatively smooth consumption patterns in the face of interruptions of income growth. 10/ This does little, however, to explain the current low saving rate, which has persisted well into the economic expansion.

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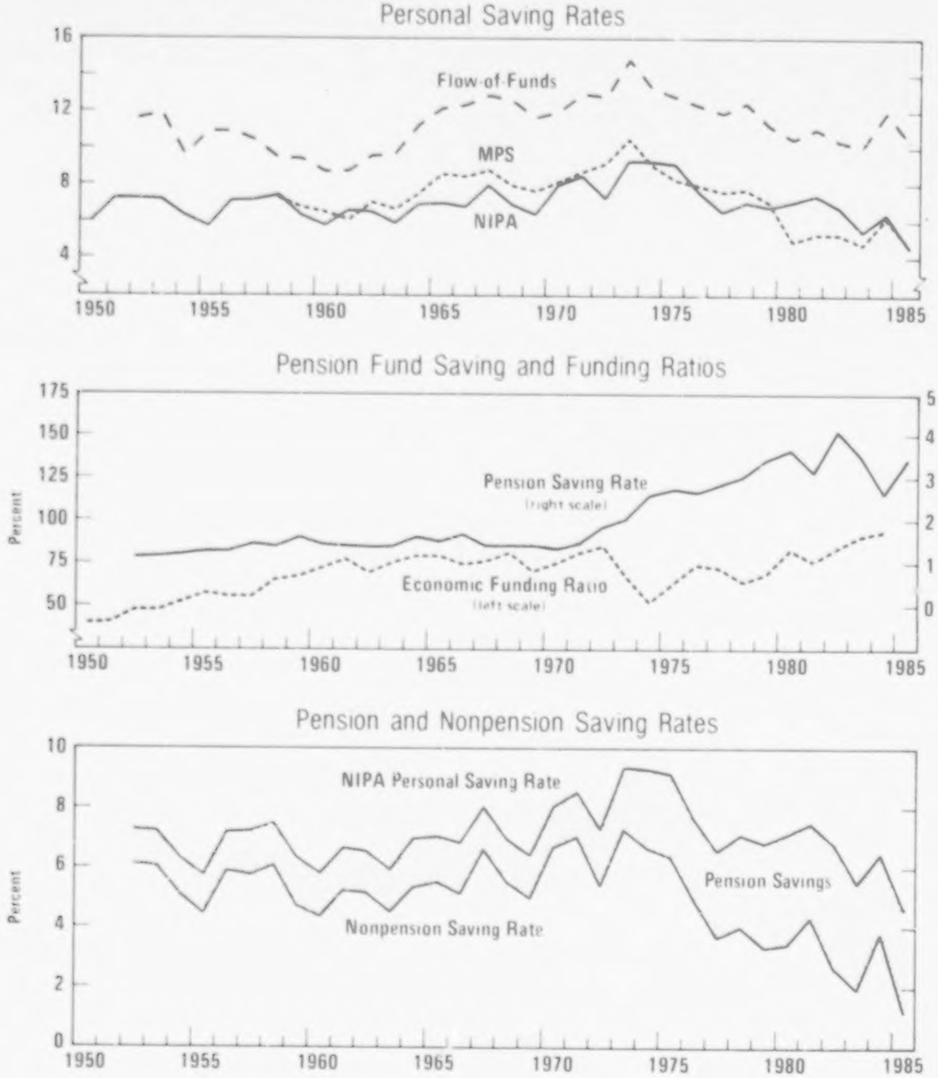
9. The saving rate was revised upward with the recent NIPA revisions. The revised data still show a significant decline since the late 1970s, however.

10. Another factor that can explain shifts in saving is a changing age composition of the population. People often save little when they are very young or very old. As a result, the overall saving rate can drop if the proportion of the population that is accounted for by these groups rises. Most analysts doubt, however, that this is a significant factor behind the relatively abrupt decline in the saving rate experienced in the last year.

Figure I-12.

Personal Saving Behavior



SOURCES: Congressional Budget Office; U.S. Department of Labor, Office of Pension and Welfare Programs; Federal Reserve Board; U.S. Department of Commerce, Bureau of Economic Analysis.

NOTES: Flow-of-Funds: approximately, saving plus net purchases of durable goods (purchases less depreciation of the existing stock) and additions to government life insurance and retirement accounts.

MPS: includes in saving purchases of durable goods, but subtracts their imputed service flows.

NIPA: the basic National Income and Product Accounts personal saving rate.

Pension Saving Rate: net acquisitions of private pension funds as a percent of personal disposable income.

Economic Funding Ratio: ratio of pension fund assets to the present value of obligations.

Purchases of durable goods rose much faster than overall consumption in 1985, but unevenly because of swings in auto sales. Spurred by factory discounts and financing incentives, auto purchases rose very sharply in the third quarter and declined in the fourth quarter as sales incentives ended. Real new auto purchases were up 6.9 percent in 1985 over 1984; consumer durables as a whole were up 8.2 percent. A new round of financing incentives spurred auto sales again in early 1986, but the increase is likely to be short-lived, as it was last year.

Purchases of durables are often erratic. Such movements act to shift the measured saving rate. Durable goods are not consumed immediately, of course, and may last many years. Even allowing for this, however, the personal saving rate still appears low.

Net Worth. Relatively strong household net worth may account for much of the recent pattern of strong consumption and weak saving. The ratio of net worth to disposable income has been higher all through the 1980s than at any time in the 1970s, although its rate of increase has been slowing. The measured saving rate tends to be low when household net worth is relatively high, and vice versa. When net worth is high, people feel that their futures are well provided for, and that they have less need to save.

This type of behavior is also evident in the management of private pension funds, where developments directly affect the NIPA measure of personal saving. As Figure I-12 shows, when the funding ratio--a measure of the assets of a pension fund relative to its current and future obligations--is high, net acquisitions of the fund, principally employer contributions, tend to slow. Because these contributions are included in personal savings, a slowing reduces the measured rate of personal saving. The figure breaks the personal saving rate into pension fund saving--net acquisition of pension fund assets--and nonpension saving. The relative pace of pension fund saving has slowed noticeably in the 1980s consonant with the increase in the funding ratio, and this has contributed to the decline in the overall NIPA saving rate. The decline in nonpension saving has been even more significant.

Consumer Debt. The ratio of consumer installment debt to disposable personal income is at an all-time high of 18.9 percent, but this in itself may not be cause for serious concern. Overall, household net asset and liquidity positions have improved significantly during the 1980s. In addition, falling interest rates are expected to ease the burden of installment purchases. On the other hand, the delinquency rate on consumer debt has recently edged upward to 2.4 percent in the third quarter of 1985 from 2.1 percent a year earlier.

The Outlook for Consumption. CBO anticipates that consumption will continue to grow moderately, though somewhat more slowly than the economy as a whole, during the next year. But the outlook is very uncertain. If interest rates are not as low as market participants currently expect, or if the stock market falls for some other reason, the value of existing assets will fall. This could lead to a retrenchment in consumption as households acted to rebuild their net asset positions.

Uncertainty surrounding the exact method of satisfying the budget deficit targets in fiscal year 1987 adds to the difficulty in forecasting consumption. There is no basis yet for predicting the particular changes in federal spending and, possibly, taxes that may occur, so the effects of the legislation on consumption cannot be gauged.

Business Fixed Investment

Business fixed investment had another good year in 1985, although its growth slowed substantially from the pace of the previous year (see Table I-13). Spending on equipment followed a seesaw pattern with much of the instability concentrated in two major categories: autos and trucks, and office equipment (which includes computers). The introduction of a new generation of mainframe computers was one of the factors contributing to the uneven pattern in spending for equipment. Real investment in structures slowed sharply after the first quarter and continued growing relatively slowly after that.

TABLE I-13. RECENT TRENDS IN BUSINESS FIXED INVESTMENT
(Percent change at annual rates)

				1985			
	1983	1984	1985	I	II	III	IV
Nonresidential Structures	-9.5	14.6	11.4	19.8	5.2	1.2	6.4
Producers Durable Equipment	3.2	22.2	8.7	-10.2	16.9	3.0	12.4
Total	-1.8	19.5	9.6	-0.5	12.5	2.4	10.3
Real GNP	3.4	6.6	2.3	3.7	1.1	3.0	2.3

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

In spite of the decline in its *growth rate*, the *level* of real business investment in 1985 remained high owing to its very rapid growth the previous year. Thus, though investment did not contribute strongly to growth in demand, it continued adding to productive capacity. The sharp slowing in its growth in 1985 may have come in response to the smaller slowdown in the growth of overall output. Such an exaggerated investment response is to be expected in the framework of the textbook "accelerator" theory of business investment. The pattern is also typical of postwar recoveries, although it has generally occurred earlier in the expansion than was true last year.

Much of the recent growth in business structures has been concentrated in commercial buildings, such as office buildings, stores, and warehouses. The boom in office building has continued despite extremely high office vacancy rates, but it now appears to be slowing. Tax considerations, particularly proposals to end some of the tax advantages of the real estate industry, may have helped to prolong the boom in office building.

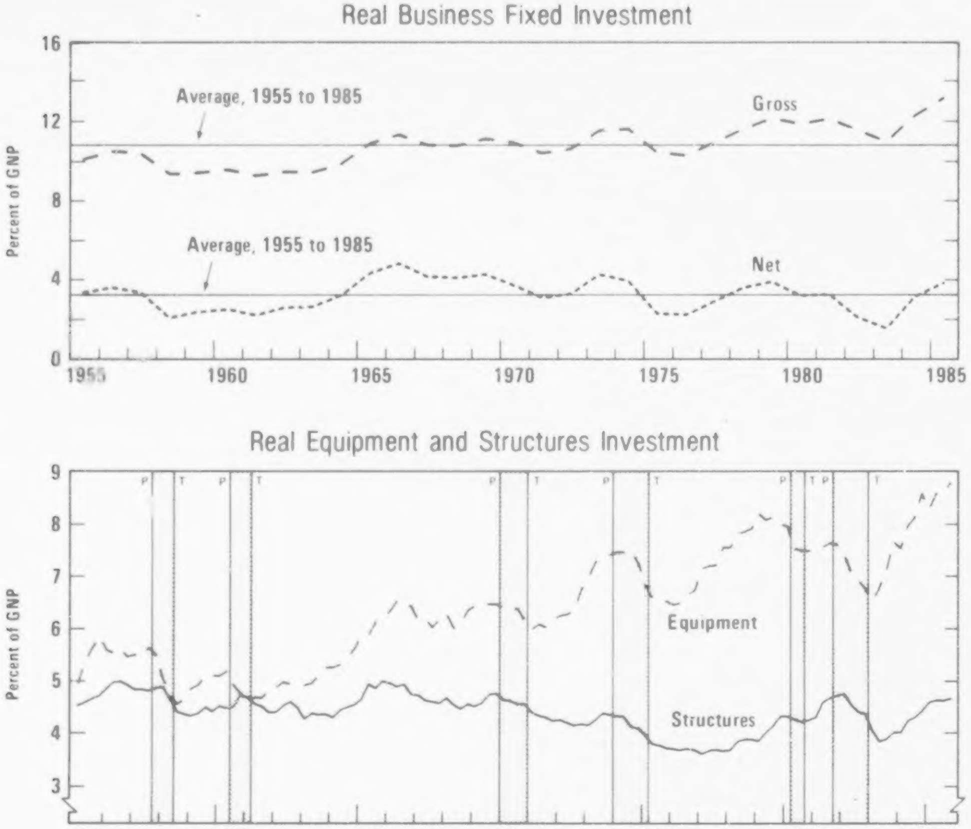
The recent performance of business fixed investment is placed in historical perspective in Figure I-13. Real gross investment as a percent of GNP has recently been at record levels. But net investment--what remains after worn-out and obsolescent capital is replaced--is only at an average level by historical standards. This reflects the fact that the share of GNP spent on equipment, which is relatively short-lived, has been rising over time, while the structures share has remained relatively flat. The figure also shows that the recovery in both gross and net investment from the 1982 recession has been particularly sharp, although much of this expansion in domestic investment has been financed by a lowering of the net U.S. foreign capital position.

The Outlook for Business Fixed Investment. Current indicators of the outlook for business fixed investment are mixed (see Table I-14). One near-term bellwether, new orders for nondefense capital goods, was up 5.7 percent in the third quarter but rose less sharply in the fourth quarter. December new orders were up sharply (18.6 percent), but the gain was probably temporary, since it reflected bunching in aircraft orders. Capital appropriations of large manufacturing firms fell about 8 percent in the second quarter and another 11 percent in the third quarter. The capacity utilization rate in manufacturing has been essentially flat for the last two years. At roughly 80 percent, capacity utilization has been holding about two percentage points below the average rate for the 1967-1984 period.

By far the most positive signs for business investment are financial data. Corporate profits, adjusted to remove the effects of inventory price changes and to reflect economic rather than tax-related depreciation, have been quite strong in the current recovery. In the third quarter of 1985, for example, profits were up 14 percent from year-ago levels. The net cash flow of corporations, which includes depreciation and retained earnings, also showed strong growth in 1985. The most dramatic recent development in the financial area, however, has been the decline in interest rates and the rise in the stock market--both of which bode well for business investment. The interest rate on high-quality corporate bonds, a measure of the cost of borrowing to finance investment, declined two full percentage points from the third quarter of 1984 to the third quarter of 1985 and another half point

Figure I-13.

Business Investment


Real Business Fixed Investment

Real Equipment and Structures Investment

SOURCES: Congressional Budget Office; U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: Investment and GNP are in constant 1982 prices. Net investment is gross investment minus economic depreciation. Data for gross and net investment are annual; data for equipment and structures are quarterly.

TABLE I-14. CURRENT INDICATORS OF BUSINESS FIXED INVESTMENT AND SURVEYS OF CAPITAL SPENDING PLANS FOR 1986

			1984			1985				
	1984	1985	I	II	III	IV	I	II	III	IV
Current Indicators										
Nondefense Capital Goods Orders (billions of dollars per month)	26.9	27.3	26.5	27.5	27.4	26.3	26.8	26.3	27.8	28.1
Manufacturers' Capital Appropriations (billions of dollars, annual rate) a/	116.0	N.A.	115.6	136.4	109.2	116.4	119.6	110.4	98.0	N.A.
Manufacturing Capacity Utilization Rate (percent)	80.8	80.3	79.9	80.7	81.6	81.0	80.5	80.3	80.3	79.9
Corporate Economic Profits (billions of dollars, annual rate) b/	273	N.A.	268	278	271	276	282	288	309	N.A.
Corporate Net Cash Flow (billions of dollars, annual rate) c/	358	N.A.	345	355	363	370	381	390	409	N.A.
Corporate AAA Bond Rate (percent)	12.7	11.4	12.3	13.2	13.0	12.4	12.3	11.6	11.0	10.5
Standard and Poor's 500 Stock Index (annual percent change)	0.0	16.4	-12.4	-11.0	12.9	12.1	32.7	18.0	7.8	19.7

Surveys of Capital Spending Plans for 1986

	Nominal	Real
U.S. Department of Commerce d/	2.4	-1.0
McGraw-Hill Survey e/	-1.0	-5.4

SOURCES: Congressional Budget Office; U.S. Department of Commerce, Bureau of Economic Analysis; McGraw-Hill, Inc.; Conference Board; Federal Reserve Board.

NOTE: N.A. = not available.

a. Because of the seasonal adjustment procedure, the annual figure does not equal the average of the quarterly figures.

b. Economic profits are adjusted for inventory valuation and capital consumption allowances.

c. Net cash flow equals corporate retained earnings with inventory valuation adjustment, plus economic depreciation.

d. Conducted in October and November 1985.

e. Conducted in September and October 1985.

in the fourth quarter. Higher stock market prices mean lower costs of investment through equity finance.

On the negative side, uncertainty about tax policy may be holding back investment plans in some sectors. Moreover, surveys of business investment plans for 1986 have been pessimistic. The survey conducted by the Commerce Department in late October and November showed planned investment up 2.4 percent above the 1985 level in nominal terms and down 1.0 percent after adjusting for price changes. The McGraw-Hill survey suggested even lower levels, although it was conducted earlier in the fall and is not adjusted for systematic biases in reporting. It should be noted, however, that neither of these surveys fully reflects the recent decline in interest rates.

Inventories

Business inventory investment showed a substantial decline in 1985 from the record accumulation of the previous year. The pace of inventory accumulation began to slow in late 1984, and inventories actually declined in the third quarter of 1985 for the first time in over two years. The decline was primarily the result of the liquidation of hefty stocks of passenger cars, as well as a decline in farm inventories. Inventories rose again in the fourth quarter as consumption declined and automobile manufacturers restocked their inventories, hoping that a new round of financing incentives would encourage sales in early 1986.

Figure I-14 shows that the real inventory-sales ratio has fallen since late 1983 to levels last seen in the early 1970s. [11] One plausible explanation of this relatively laggard pace of inventory investment is that the net return to holding inventories has declined. The current expansion has been accompanied by relatively high real interest rates, which raise the opportunity cost of holding inventories. Moreover, in contrast to other postwar recoveries, there has been no acceleration in producer-price inflation, and this weakens the speculative motive to hold inventories. Together, these two factors may have made inventory holding relatively unattractive in the current expansion.

The Outlook for Inventory Investment. Except for autos, inventories now appear generally to be low relative to sales. The rate of inventory investment seems unlikely to decline much farther. The CBO forecast sees it increasing in the near term and then returning to trend as real interest rates soften and inflation picks up slightly. A stronger increase could occur temporarily, however, if consumption grows less strongly than producers expect.

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[11] Before the recent revision in NIPA data, the real inventory-sales ratio was thought to be near a record low. The revisions raised the real inventory-sales ratio, which is now below the range established since the mid-1970s but within the longer-term historical range.

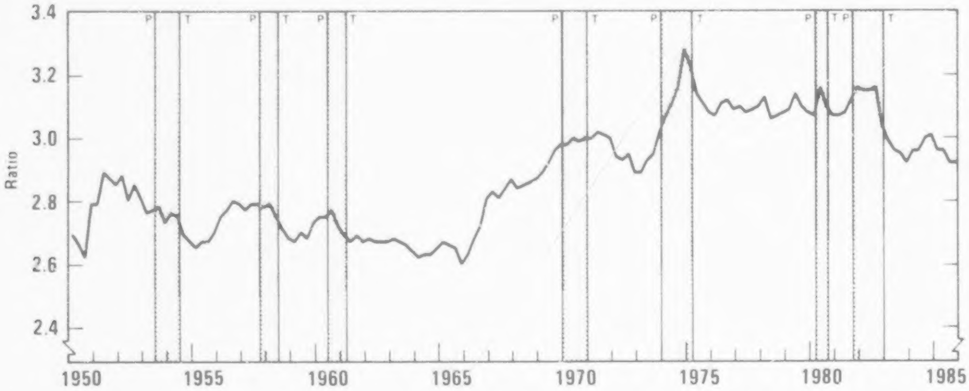
Residential Construction

Despite the lowest interest rates in years, housing construction remained inexplicably weak over much of 1985. Housing starts, which averaged only about 1.7 million units in 1985, began last year at a relatively healthy pace; slowed during the year, and rebounded at year-end. The slowdown was blamed on a number of factors, such as relatively high inventories of new homes, tightening of secondary market underwriting standards, severe weather, and uncertainty caused by prospective changes in tax laws.

The sharp rise in starts at year-end may signal a recovery in residential construction in 1986. Financial conditions appear to be favorable, and mortgage interest rates may fall somewhat farther in 1986. This drop, combined with the fact that housing price increases are likely to be modest, should make it easier to afford a new house than at any time since the late 1970s. Inventories of single-family homes are now low enough to allow any pickup in new-home purchases to be translated quickly into starts. In addition, the most recent tax proposals have maintained the interest exclusion on second homes and the deductibility of real estate taxes. The final form of this legislation is still unclear, but market

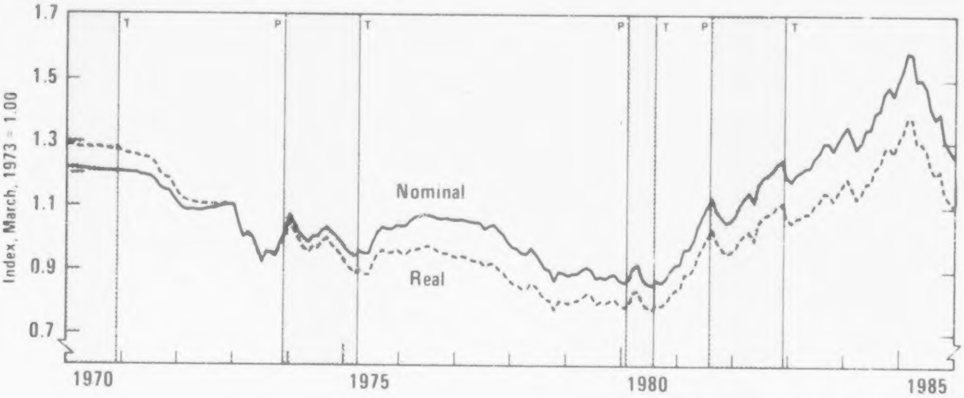
Figure I-14.

Real Inventory-Sales Ratio, Nonfarm Business



SOURCES: Congressional Budget Office; U.S. Department of Commerce, Bureau of Economic Analysis.

Figure I-15.
Exchange Rate



SOURCES: Congressional Budget Office, Federal Reserve Board, International Monetary Fund.

NOTE: The nominal index is a trade-weighted average of bilateral dollar exchange rates. The real index adjusts the nominal index for relative movements in CPIs, and is a measure of the relative prices of domestic and foreign goods and services.

expectations have probably become more optimistic. Finally, sufficient mortgage credit should be available to finance a pickup in construction.

Net Exports

The international value of the dollar trended downward over the last three quarters of 1985, falling quite sharply at times, to a monthly average for December nearly 21 percent below that for February (see Figure I-15). Thus, the long upward trend of dollar appreciation that began in the third quarter of 1980 was rolled back approximately to mid-1983 levels.

A number of forces caused this turnaround. Slack in the domestic economy, an accommodating U.S. monetary policy, and an improved likelihood of eventual action on the federal deficit caused real interest rates in the United States to fall relative to those abroad, thereby reducing the attractiveness of dollar assets (see Figure I-16). When the dollar threatened to strengthen again in the late summer, the Group of Five (G5) major industrial nations (France, Japan, the United Kingdom, the United States, and West Germany) responded by calling for further orderly depreciation of the dollar, and pledged cooperation to encourage this outcome. In effect, the United States substantially revised its stance against official intervention in currency exchange markets. 12/

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12. Intervention is the buying or selling of currencies by official monetary authorities.

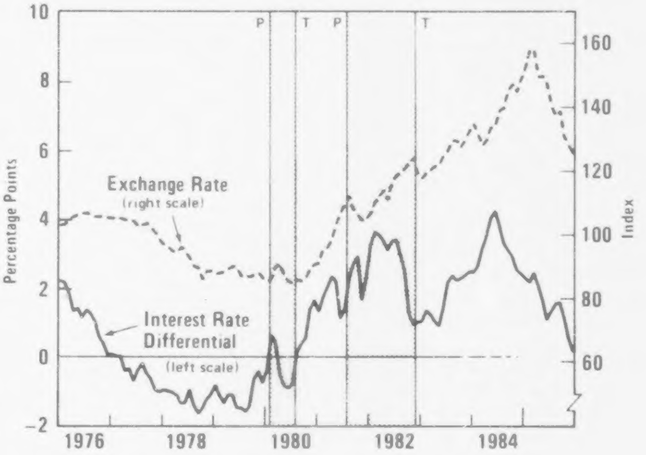
Because trade responds to exchange-rate movements with a considerable lag, the decline in the dollar exchange rate last year has so far had little observable effect on U.S. international trade. Net exports continued to fall last year, but revisions in the trade data make it especially difficult to assess the present situation. One reason for the unusually large recent revisions of the trade data is to correct for reporting delays that distort the measurement of actual trade flows and thereby also of GNP growth rates (see Box I-4).

The Trade Deficit and the Standard of Living. One consequence of the large current-account deficits in recent years is that foreigners have been acquiring more and more assets in the United States, such as business capital, real estate, and government bonds, as a result of this country's need to sell dollar-denominated assets to other countries in order to finance the balance-of-trade deficit.

That foreigners own more and more productive capital in this country is reflected in the difference between the growth rates of gross national product (GNP) and gross domestic product (GDP). Broadly speaking, GDP represents the output produced by labor and capital located in the United States, regardless of who owns it. GDP differs from the more familiar GNP measure, which represents, broadly, the flow of production from labor and capital owned by U.S. residents regardless of where it is located in the

Figure I-16.

The Exchange Rate and Relative Interest Rates



SOURCES: Congressional Budget Office; Federal Reserve Board; International Monetary Fund.

NOTE: The exchange rate is a trade-weighted average of bilateral dollar exchange rates. The real interest-rate differential is the difference between long-term real interest rates for the United States and a GDP-weighted average for other industrial countries. Long-term real interest rates are long-term nominal interest rates (on government bonds), adjusted for expected inflation rates. Expected inflation is proxied by a two-year centered moving average of actual and projected CPI inflation rates.

BOX I-4

MERCHANDISE TRADE DATA REPORTING PROBLEMS

Recently the Bureau of the Census revealed that as much as one-half of the value of imports normally reported during what is termed a statistical month actually entered the economy in previous months. Such delays occur because of lags between the actual passage of imported goods through Customs and the receipt by the Census Bureau of the underlying documents. This problem has serious implications for the National Income and Product Accounts (NIPA). The NIPA data are based in part on Census Bureau trade flow reports, and are meant to register current economic developments, rather than the receipt of the corresponding documentation.

Discrepancies between statistical and actual-month import values since the beginning of 1984 ranged from less than $0.1 billion to $4.2 billion, averaging $1.8 billion per month or about 6 percent of average monthly import values. At least nine times over the last two years, statistical data misstated the direction of change of actual imports in a given month. The Census Bureau advises that at least four months of data are needed before actual monthly import values can be estimated accurately.

Recent broad revisions of the NIPA by the Department of Commerce's Bureau of Economic Analysis (BEA) include all available information on actual trade flows. For contemporaneous-quarter GNP calculations, BEA now relies primarily on its own estimates of trade flows rather than on reported statistical-month data. Although this procedure improves the ultimate accuracy of the NIPA data, it also increases the likelihood that significant revisions will have to be made as the actual trade data become available.

world. Net inflows of foreign capital reduce GNP relative to GDP because the income earned by foreign-owned capital in this country is reflected in GDP but not in GNP (see Box I-5).

In the past four years, the growth rate of real GDP exceeded that of real GNP by an average of 0.2 percentage points (see Table I-15). The difference can be viewed as the price that the United States is beginning to pay, in terms of reduced income, for having borrowed so much abroad.

The Outlook for Net Exports. CBO forecasts a gradual turnaround in the foreign trade deficit. The real net export deficit (measured in 1972 prices) should bottom out this year, even though deficits on merchandise trade and on current account will continue to grow in nominal terms. The improvement will not be rapid, however, partly because one component of the current account--net factor income--will continue to decline. Net factor income flows are expected to decline in both nominal and real terms over the forecast horizon. This decline reflects the fact that the United States will still have to borrow abroad on a net basis in order to finance its large current account deficits. Another factor contributing to delay in the improvement in the balance-of-trade deficit is the fact that the decline in the dollar may be partly absorbed as smaller profit margins for importers and foreign exporters, rather than being fully reflected in rising import prices.

The U.S. trade position may also be buffeted by events overseas. Increasing balance of payments difficulties in third-world countries could lead to a flight of capital from these countries to the United States, tending to push the dollar upward again unless confidence in the U.S. banking system were severely eroded at the same time.

Other factors that make the outlook uncertain: If major trading nations fail to agree on new multilateral measures to reduce barriers to trade, protectionist tendencies could grow, restricting the level of trade worldwide. Or a further tightening of monetary policy abroad could cause the dollar to fall much more than it does in CBO's forecast. In that case,

TABLE I-15. GROWTH RATES OF REAL GNP AND GDP, 1982-1985
(In percents)

	1982	1983	1984	1985
GDP	-2.5	3.6	6.9	2.6
GNP	-2.5	3.4	6.6	2.3
Difference	0.0	0.2	0.3	0.3

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

BOX I-5

NET FACTOR INCOME FLOWS

In the National Income and Product Accounts (NIPA), the gross national product (GNP) is the sum of gross domestic product (GDP) and income earned abroad by U.S. residents, minus income earned in the United States by foreign residents. In more succinct terms, GNP equals GDP plus net factor income flows. The growth rate of real GNP for the past four years has been significantly lower than that of real GDP because, on average, net factor income has declined.

Declining net factor income flows have been primarily the result of declining net flows of capital income--that is, interest and profits. The gross flows of capital income are determined by the stock of U.S.-owned foreign assets, the stock of foreign-owned U.S. assets, and their respective rates of return. (As a matter of convention, interest on U.S. government liabilities is treated as a transfer payment in the NIPA, rather than as a flow of income. Hence, in computing net factor income flows, interest payments to foreign holders of U.S. government liabilities are ignored.)

The United States has had to borrow abroad on a net basis in order to finance its large current-account deficits, and, consequently, foreign-owned U.S. assets have grown more rapidly than U.S.-owned foreign assets in recent years. As a result, sometime during 1985 the United States became a net debtor nation. The deterioration of the U.S. net foreign asset position has been accompanied by a decline in net factor income flows. This decline will continue in both nominal and real terms as long as the United States runs a trade deficit, implying a real GNP growth rate smaller than the real GDP growth rate well into the future.

A change in relative rates of return on U.S. and foreign assets can have a substantial impact on net factor income flows. If the relative rate of return on foreign-owned U.S. assets were to rise by a full percentage point in, say, 1986 (all other things being equal), then net factor income flows would fall by roughly $8 billion, subtracting about 0.2 percentage points from the real GNP growth rate but leaving GDP growth unchanged. Generally, converse movements in relative rates of return would yield symmetrically converse results.

Finally, changes in the portfolio composition of foreign-owned U.S. assets can have significant effects on measured net factor income flows. If foreign residents increase their holdings of U.S. government securities by shifting out of U.S. private securities, this raises both measured net factor income flows and the real GNP growth rate for the United States. Thus, as a result of an accounting convention, it is possible for measured net factor income flows to move in one direction even though net international receipts on total interest and profits move the other way. If foreign residents could convert their 1985 stock of U.S. private assets to U.S. government securities (all other things remaining equal), the resulting increase in net factor income would by 1987 raise the U.S. real GNP growth rate by a full percentage point above the growth rate of real output.

the competitive position of American producers would be enhanced, but the induced slowdown in foreign growth rates would tend to depress the demand for U.S. exports below the levels incorporated in CBO's forecast.

Government Purchases

The growth of government purchases, excluding the activities of the Commodity Credit Corporation (CCC), slowed in 1985.

The Federal Sector. On a National Income and Product Accounts (NIPA) basis, the growth of real federal purchases (excluding the CCC) amounted to 5.3 percent in 1985, down from 5.4 percent the previous year and 6.1 percent in 1983 (see Table I-16). The growth in 1985 mainly reflected an increase in defense spending (concentrated in the third quarter), especially for durable goods such as ships and vehicles. Overall, defense purchases rose by 7.1 percent, the second highest annual growth since 1967.

TABLE I-16. GOVERNMENT PURCHASES OF GOODS AND SERVICES
(By calendar year, on a national income accounting basis)

				1985			
	1983	1984	1985	I	II	III	IV
			Billions of 1982 Dollars				
Federal a/	279.7	294.7	310.2	300.5	305.7	318.1	316.5
Defense	207.3	220.3	236.0	226.7	231.5	243.3	242.6
State and Local	372.2	383.3	394.2	387.1	393.6	398.1	398.0
Structures	42.9	45.6	48.9	44.2	49.2	51.9	50.4
			Percent Change b/				
Federal a/	6.1	5.4	5.3	-5.9	7.1	17.2	-2.0
Defense	7.0	6.3	7.1	-2.1	8.7	22.0	-1.1
State and Local	0.9	3.0	2.8	0.5	6.9	4.7	-0.1
Structures	-0.2	6.3	7.2	-7.7	53.5	23.8	-11.0

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

a. Excludes purchases and sales by the Commodity Credit Corporation.

b. For calendar years, the percent change is calculated year over year.

Real federal purchases are expected to show some growth in 1986, despite cuts in spending needed to meet the deficits targets of the Balanced Budget Act. In 1987, however, the level of purchases is expected to decline, especially if the deficit target in that year is achieved through sequestration.

The State and Local Sector. Real purchases of goods and services by state and local governments rose by 2.8 percent in 1985, compared with 3.0 percent in 1984 and 0.9 percent in 1983 (see Table I-16). Most of this growth was in construction spending, which increased by 7.2 percent--one of the fastest growth rates in more than two decades. Highway and school-related construction were two important components of it. Construction is expected to grow more slowly during the forecast period. As the level of construction expenditures flattens, the growth of total state and local purchases is also expected to slow.

The operating surpluses of states and localities declined from a record $15.9 billion in 1984 to an estimated level of roughly $5 billion in 1985. By the third quarter of 1985, these surpluses were at their lowest level ($3.3 billion) since the recession-related deficits of 1982. State and local operating balances are likely to remain small, and possibly (on a NIPA basis) turn into deficits during the forecast period. Already scheduled cuts in federal grants (including the elimination of general revenue sharing in 1987) and likely additional cuts in grants to achieve the targets of the Balanced Budget Act are therefore likely to lead to further retrenchment on the spending side or to increases in some state and local taxes.

CHAPTER II

THE BUDGET OUTLOOK

The Congressional Budget Office projects that the baseline federal deficit will fall from $208 billion in fiscal year 1986 to $181 billion in 1987 and to $104 billion in 1991, assuming that defense and nondefense appropriations are held constant in real terms and that tax and entitlement laws are continued. While the federal debt will continue to grow as long as the government runs deficits, the rate of growth of the debt is projected to slow substantially. In relation to gross national product (GNP), the debt will increase from 38.4 percent at the end of 1985 to 42.7 percent by the end of 1988 but then begin to decline at a modest rate. Table II-1 summarizes the CBO baseline projections for total federal revenues, outlays, and the deficit, including off-budget items. Projections for on-budget and off-budget activities are shown separately in Box II-1.

Revenues grow more rapidly than outlays under the policy assumptions of the CBO baseline, because revenues are boosted by inflation and increases in real incomes, while outlays rise only slightly faster than the rate of inflation. Revenues rise somewhat more rapidly than nominal GNP in 1987 and 1988 and at about the same rate thereafter. Outlays are projected to rise at a rate of 4.8 percent per year--only slightly above the projected inflation rate of 4.1 percent. Revenues thus remain a roughly constant share of GNP, while outlays and the deficit fall, as Figure II-1 shows.

In 1987 outlays grow less rapidly than their 1986-1991 trend rate, while revenues increase more rapidly than trend. As a result, the deficit drops by $27 billion in 1987--more than in any later year. The major factor slowing 1987 outlay growth is a projected $6 billion drop in Commodity Credit Corporation (CCC) spending for farm price supports. The rapid rise in revenues in 1987 is caused by a pickup in personal income growth and the delayed effect of strong growth in corporate profits in 1986.

BASELINE BUDGET PROJECTIONS

The CBO baseline budget projections assume CBO's short-run economic forecast and longer-run projections, as described in the previous chapter. They also assume that current taxing and spending policies will continue unchanged for fiscal years 1987 through 1991. The projections are not forecasts of future federal budgets, since those budgets will doubtless include numerous policy changes. They are, however, a baseline or benchmark against which proposed policy changes can be measured.

In preparing the baseline projections, CBO must adopt a number of conventions or assumptions as to what constitutes current budgetary policies. In many cases, the choice of assumptions can substantially affect the projections. This section summarizes those assumptions; they are described in detail in Apppendix A.

Baseline Revenues

CBO baseline revenues are, with one exception, identical to the base revenues used to compute the excess deficit under the Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177). (A detailed

TABLE II-1. CBO BASELINE BUDGET PROJECTIONS
(By fiscal year)

	1985 Actual	1986 Base	Projections				
			1987	1988	1989	1990	1991
In Billions of Dollars							
Revenues	734	778	844	921	991	1,068	1,144
Outlays	946	986	1,025	1,086	1,135	1,188	1,248
Deficit	212	208	181	165	144	120	104
Debt Held by the Public	1,510	1,720	1,900	2,064	2,207	2,326	2,429
As a Percent of GNP							
Revenues	18.6	18.6	18.7	19.0	19.0	19.0	18.9
Outlays	24.0	23.5	22.8	22.4	21.8	21.2	20.6
Deficit	5.4	5.0	4.0	3.4	2.8	2.1	1.7
Debt Held by the Public	38.4	41.0	42.2	42.7	42.3	41.4	40.2
Reference: GNP (In billions of dollars)	3,937	4,192	4,504	4,838	5,214	5,619	6,047

SOURCE: Congressional Budget Office.

BOX II-1

ON-BUDGET AND OFF-BUDGET SPENDING AND REVENUES

The total outlays and revenues of the federal government include both on-budget and off-budget activities. On-budget and off-budget activities must be added together, however, to determine the total federal deficit that must be financed by borrowing from the public. The estimated total deficit is also used in calculating the excess deficit amount for purposes of the Balanced Budget Act.

In 1969, at the recommendation of the President's Commission on Budget Concepts, the government adopted a unified budget, which provided a comprehensive summary of federal revenues and spending. The unified budget was intended to give an accurate portrayal of the economic importance of government activities and to enable policymakers to control spending and tax policies more effectively. Starting in 1971, the unified budget concept became compromised by the exclusion of certain spending programs--primarily the lending activities carried out through the Federal Financing Bank and the purchase of oil for the Strategic Petroleum Reserve. The 1985 Balanced Budget Act returned all of these previously off-budget entities to the budget. Simultaneously, however, it moved off-budget the two Social Security trust funds--Old-Age and Survivors Insurance and Disability Insurance (OASDI).

This volume focuses on total federal government fiscal activities because of their significance for the economy and for implementing the Balanced Budget Act. Of the total amounts, however, Social Security represents roughly 19 percent of outlays and 25 percent of revenues. Moreover, the Social Security trust funds will be in surplus, while the on-budget activities will be running substantial deficits, as shown in the following table.

(In billions of dollars)

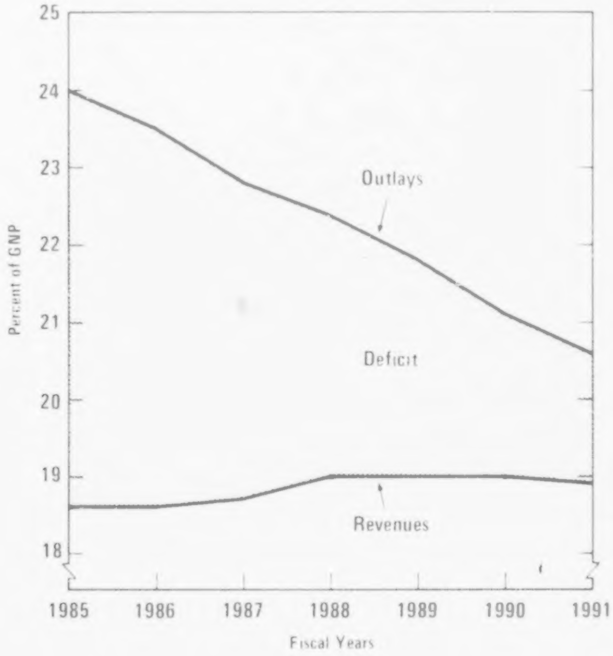
	1986	1987	1988	1989	1990	1991
Revenues						
On-budget	580	631	680	730	781	832
Off-budget (OASDI)	198	213	241	261	287	312
Total	778	844	921	991	1,068	1,144
Outlays						
On-budget	802	827	876	913	953	999
Off-budget (OASDI)	184	198	210	222	235	249
Total	986	1,025	1,086	1,135	1,188	1,248
Deficit (-) or Surplus						
On-budget	-222	-196	-195	-183	-172	-167
Off-budget (OASDI)	14	15	31	39	52	63
Total	-208	-181	-165	-144	-120	-104

discussion of this legislation, called the Balanced Budget Act for short, may be found in Chapter III.) The act specifies that the revenue base is to assume that current tax laws continue unchanged and that expiring provisions will terminate as scheduled except for excise taxes dedicated to trust funds. In the same way, the baseline assumes that taxes for the Hazardous Substance Response (Superfund), Airport and Airway, and Highway Trust Funds are extended at the rates in effect on their expiration dates. In contrast to the revenue base for the Balanced Budget Act, however, the baseline assumes that the reduction in the civil service contribution rate for recently hired workers is extended beyond April 30, 1986.

Baseline Outlays

Federal spending can be divided into two categories. The first category--mandated by existing law--includes spending for Social Security benefits and other entitlement programs, for permanent appropriations such as interest

Figure II-1.
Federal Revenues, Outlays, and Deficit as Percents of GNP



SOURCE: Congressional Budget Office.

on the public debt, and for most trust funds and other special funds. The baseline spending projections for these programs are comparable with the Balanced Budget Act's outlay base, which assumes continuation of current law and termination of expiring provisions. Unlike the outlay base in the Balanced Budget Act, however, the CBO baseline assumes that the general revenue sharing program will be continued beyond 1986 and that cost-of-living adjustments will be provided for veterans' compensation.

The 1986 outlay estimates for mandatory spending programs reflect the sequestration of 1986 spending authority as required by the Balanced Budget Act. For programs with cost-of-living adjustments (COLAs), sequestering the 1986 COLA also reduces outlays in all future years. For most other mandatory programs, such as Medicare or farm price supports, 1987 spending authority is assumed to return to presequestration levels, so that no long-run reduction in outlays occurs.

Federal spending not mandated by existing law is controlled through the appropriation process. The fiscal year 1986 spending level assumed for these programs is the level enacted by the Congress through December 1985 and reduced according to the provisions of the Balanced Budget Act. The 1987-1991 projections generally assume that the 1986 postsequestration program level is adjusted to keep pace with inflation.

The baseline for appropriated accounts differs from the outlay base defined in the Balanced Budget Act. If appropriations for the fiscal year have not been enacted, the outlay base estimates under the Balanced Budget Act are to assume appropriations equal to those enacted for the previous year. The outlay base for the Balanced Budget Act thus excludes discretionary inflation and other adjustments made to keep baseline program levels constant in real terms. The CBO baseline, in contrast, includes these adjustments.

CHANGES IN BASELINE BUDGET PROJECTIONS SINCE AUGUST 1985

When CBO last published its budget projections in August 1985, baseline deficits were projected to continue growing in dollar terms and to remain a level 5.1 percent of GNP. In comparison with these baseline projections of six months ago, the present baseline projections seem surprising. (The major changes in the baseline are listed in Table II-2.) The projections are not strikingly different, however, from CBO's August reestimate of the Congressional budget resolution, which showed deficits declining from $175 bil-

TABLE II-2. CHANGES IN CBO BASELINE DEFICIT PROJECTIONS SINCE AUGUST 1985 (By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990
August 1985 Baseline Deficit	212.3	229.0	243.2	263.9	284.6
Changes Caused by					
1986 appropriations action a/					
National defense b/	-3.6	-13.8	-22.3	-42.0	-56.0
Nondefense discretionary	-6.9	-13.7	-13.9	-14.8	-15.0
Subtotal	-10.5	-27.5	-42.2	-56.8	-71.0
Effect of 1986 sequestration a/					
National defense	-5.5	-9.1	-10.6	-11.4	-12.0
Nondefense discretionary	-3.5	-5.1	-5.9	-6.3	-6.7
Entitlements	-2.5	-2.1	-1.6	-1.6	-1.7
Subtotal	-11.4	-16.3	-18.1	-19.3	-20.3
Assume zero real growth in defense spending a/	--	-3.2	-9.5	-18.0	-28.1
Net interest					
Lower interest rates	-3.3	-7.5	-11.0	-18.4	-30.6
Debt service and other c/	3.6	0.2	-5.3	-12.5	-20.4
Subtotal	0.3	-7.3	-16.3	-30.9	-51.0
Farm price supports	10.6	3.3	5.0	1.4	-3.5
Other outlays	-2.4	-5.6	-7.3	-7.7	-6.5
Lower revenues	9.5	8.9	10.1	11.0	16.0
Total Changes	-4.0	-47.7	-78.2	-120.3	-164.5
February 1986 Baseline Deficit	208.3	181.3	164.9	143.6	120.1

SOURCE: Congressional Budget Office.

a. Excludes resulting changes in net interest.
b. Assumes 3 percent real growth after 1986.
c. Includes effects of lower deficits resulting from all other changes.

lion in 1986 to $120 billion by 1990. What has happened in the past six months that has effectively validated the budget resolution projections?

First of all, the Congress adopted a 1986 budget resolution that assumed zero real growth in defense spending in 1986 and 3 percent real growth in the next two years, as opposed to about 5 percent real growth assumed in the 1985 budget resolution and in CBO's August baseline. The 1986 defense appropriation was slightly below the budget resolution target and, together with the lower rate of growth in future years, this reduces projected spending by $13.8 billion in 1987 and $56.0 billion in 1990. Appropriation action in 1986 will reduce projected nondefense discretionary spending by $13.7 billion in 1987 and $15.0 billion in 1990.

Second, the sequestering of 1986 spending authority under the provisions of the Balanced Budget Act reduces spending not only in 1986 but, as indicated above, in later years as well. The sequestration reduces 1986 outlays by $11.4 billion. Because spending authority had to be cut by about twice as much as the required outlay reduction, and because most of this reduction in spending authority is assumed to continue in later years, the savings from the 1986 sequestration will grow to $16.3 billion in 1987 and to $20.3 billion in 1990.

Third, the new CBO baseline--as described earlier--projects defense spending for 1987 and beyond on the basis of no real growth in program level, rather than the 3 percent real growth assumed in the 1986 resolution. The defense growth assumed in the August budget resolution can no longer be taken as representing current Congressional policy, because the 1986 postsequestration appropriation for defense is $16 billion below the budget resolution level. Assuming zero rather than 3 percent real growth for defense reduces the projected deficit by $3.2 billion in 1987 and $28.1 billion in 1990.

Fourth, the revised CBO short-term forecast and long-run economic assumptions feature interest rates substantially below those assumed in August. This change has been made because the Congress and the President are now committed by law to reducing the deficit in large steps each year so as to achieve a balanced budget by 1991. The reduction in assumed interest rates, together with a reduction in debt service costs from the other changes, will reduce net interest outlays by $7.3 billion in 1987 and $51.0 billion in 1990.

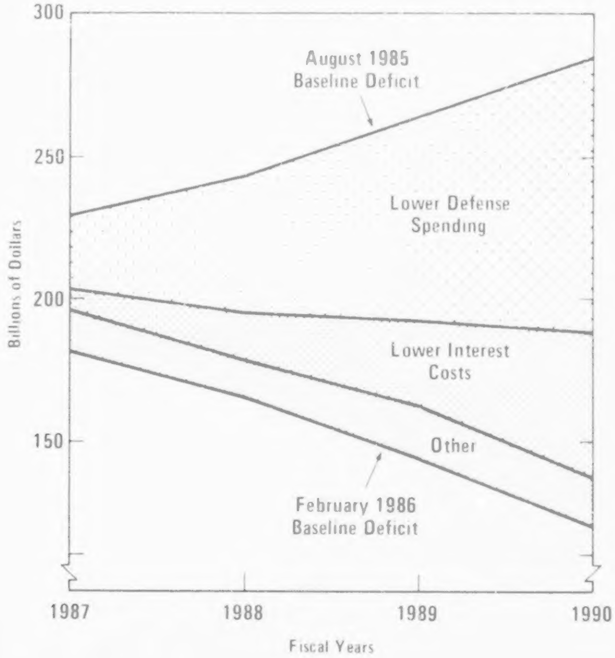
Figure II-2 adds up these changes and illustrates that almost all the reduction in the projected deficits stems from lower defense spending (both actual and assumed) and from lower interest costs. Most of the remaining reduction is attributable to decreased spending for nondefense discretionary programs. Small changes in the baseline deficits result from revised projections for farm price support spending and reductions in estimated outlays for other programs. In addition, a reduction in projected personal income reduces revenues from income and payroll taxes in every year. Higher projected corporate profits partially offset this reduction, but revenues are nevertheless $9 billion to $16 billion below the August baseline figures.

DIFFERENCES BETWEEN CBO BASELINE AND ADMINISTRATION CURRENT SERVICES PROJECTIONS

As part of its annual budget submission, the Administration presents a current services budget projection. The current services projection, like the CBO baseline, is a picture of what would happen to the budget assuming a

Figure II-2.

Sources of Change in Baseline Deficit Projections



SOURCE: Congressional Budget Office.

continuation of policies now in place. While the Administration's current services deficit projections for 1987 through 1991 are very close to the CBO baseline figures, as shown in Table II-3, the similarities in deficit projections conceal offsetting differences in certain policy assumptions and in economic and technical estimating methods.

The current services projections are based on the budget authority figures for national defense contained in the Congressional budget resolution for fiscal year 1986 and in the Administration's Mid-Session Review of the 1986 budget. Roughly speaking, the current services figures for budget authority provide for 3 percent real growth in defense starting from the 1986 appropriation assumed in the budget resolution--not from the lower postsequestration defense appropriation, as assumed in the CBO baseline. These differences in assumed defense budget authority alone cause the baseline deficit to be $7.9 billion less than the current services deficit in 1987

TABLE II-3. DIFFERENCES BETWEEN ADMINISTRATION'S CURRENT SERVICES PROJECTIONS AND CBO BASELINE
(By fiscal year, in billions of dollars)

	1987	1988	1989	1990	1991
OMB Current Services Deficit	181.8	150.0	138.9	126.3	103.9
Policy Differences					
National defense	-7.9	-18.1	-28.1	-37.6	-47.1
Hospital insurance	-0.5	-0.6	-0.6	-0.7	-0.8
General revenue sharing	3.4	4.6	4.6	4.6	4.6
Superfund taxes	0.4	0.4	0.4	0.4	0.4
Subtotal	-4.6	-13.8	-23.7	-33.4	-42.9
Economic and Technical Differences					
Interest rates a/	-1.6	3.9	12.6	24.3	32.5
National defense	7.0	10.9	10.4	10.5	11.6
Other	-1.2	13.9	5.4	-7.6	-0.9
Subtotal	4.1	28.7	28.4	27.2	43.3
CBO Baseline Deficit	181.3	164.9	143.6	120.1	104.3

SOURCE: Congressional Budget Office.

a. Net interest function only.

and $47.1 billion less in 1991. There are also three other, smaller policy differences between the Administration's current services projections and the CBO baseline. The current services projections do not reflect the Administration's intention to limit the 1987 increase in hospital insurance reimbursement rates to 2 percent above the 1986 presequestration level, while the CBO baseline includes it. The current services projection assumes the termination of general revenue sharing, while the CBO baseline does not. And current services assumes extension of Superfund taxes at a higher level than does the CBO baseline.

These differences in policy assumptions are almost exactly offset by the Administration's more optimistic economic assumptions. Except for 1987, CBO assumes higher nominal interest rates than does the Administration. These differences in interest rates cause the baseline deficit to be $32.5 billion higher than the current services deficit by 1991. CBO also projects that the level of defense budget authority assumed in current services will result in higher outlays than does the Administration. These and other estimating differences between CBO and the Administration will be discussed in more detail in CBO's forthcoming report, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1987.*

The preceding discussion has indicated three plausible assumptions for a defense baseline: (1) zero real growth from the 1986 program level after sequestration (as CBO assumes), (2) three percent real growth beginning in 1987, and (3) the defense budget authority assumed for 1987 and later years in the 1986 budget resolution (as in the Administration's current services projections). Table II-4 presents CBO's estimates of defense budget authority, defense outlays, and the deficit using these alternative defense baselines. Even with the two higher defense paths, the baseline deficit declines, although not as fast as in the zero real growth case. With 3 percent real growth in defense, the deficit falls to $185 billion in 1987 and $150 billion in 1991. Using the budget resolution figures for defense budget authority, the deficit declines to $190 billion in 1987 and to $160 billion in 1991.

BUDGET PROJECTIONS UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS

The choice of economic assumptions has a major effect on the baseline budget projections. To illustrate how changes in economic conditions can affect revenues, outlays, and the deficit, CBO has prepared two consistent alternative sets of economic assumptions, described at the end of Chapter I. These alternatives are designed to mirror typical interactions among various aspects of the economy. Table II-5 shows how the baseline deficit projections would differ under these high-growth and low-growth alternatives. This section also provides some rules of thumb for gauging the effects of changes in individual economic variables on the budget.

High-Growth Alternative

In the high-growth case, revenues are greater than in the baseline, because of both increased real incomes and higher inflation. In the first few years of the projection, outlays are lower, as a result of reduced caseloads for entitlement programs, decreased interest rates, and lower debt service costs. But in later years, all categories of outlays exceed their baseline levels in order to keep pace with the higher assumed rates of inflation and higher interest rates. (Because the CBO baseline assumes that discretionary

TABLE II-4. BASELINE PROJECTIONS UNDER ALTERNATIVE DEFENSE ASSUMPTIONS (By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990	1991
CBO Baseline (Zero Real Defense Growth)						
Defense budget authority	287	301	315	330	345	362
Defense outlays	269	284	296	311	327	344
Deficit	208	181	165	144	120	104
3 Percent Real Defense Growth						
Defense budget authority	287	310	334	360	388	419
Defense outlays	269	287	306	329	355	384
Deficit a/	208	185	175	163	152	150
1986 Budget Resolution Defense Budget Authority Targets						
Defense budget authority	287	323	347	371	397	423
Defense outlays	269	292	315	339	365	391
Deficit a/	208	190	184	175	164	160

SOURCE: Congressional Budget Office.

a. Includes additional interest costs resulting from higher defense spending.

appropriations are held constant in real terms, the calculations adjust both defense and nondefense appropriations for differences in the price level.) Because of the higher real growth, however, the increase in revenues is greater than the increase in outlays, and the deficit falls. In fact, as pictured in Figure II-3, the budget would show a surplus of $70 billion in 1991 under these assumptions.

Low-Growth Alternative

The pattern of spending and revenue changes in the low-growth alternative is generally the opposite of that in the high-growth case. Revenues are less

TABLE II-5. CBO BUDGET PROJECTIONS UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS (By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990	1991
			Revenues			
High-Growth Alternative	784	866	971	1,086	1,228	1,403
CBO Baseline Projection	778	844	921	991	1,068	1,144
Low-Growth Alternative	777	818	828	882	948	995
			Outlays			
High-Growth Alternative	985	1,020	1,082	1,147	1,229	1,333
CBO Baseline Projection	986	1,025	1,086	1,135	1,188	1,248
Low-Growth Alternative	987	1,042	1,111	1,153	1,185	1,232
			Deficit			
High-Growth Alternative	202	154	111	61	1	-70a/
CBO Baseline Projection	208	181	165	144	120	104
Low-Growth Alternative	210	224	282	271	238	237

SOURCE: Congressional Budget Office.

a. Surplus

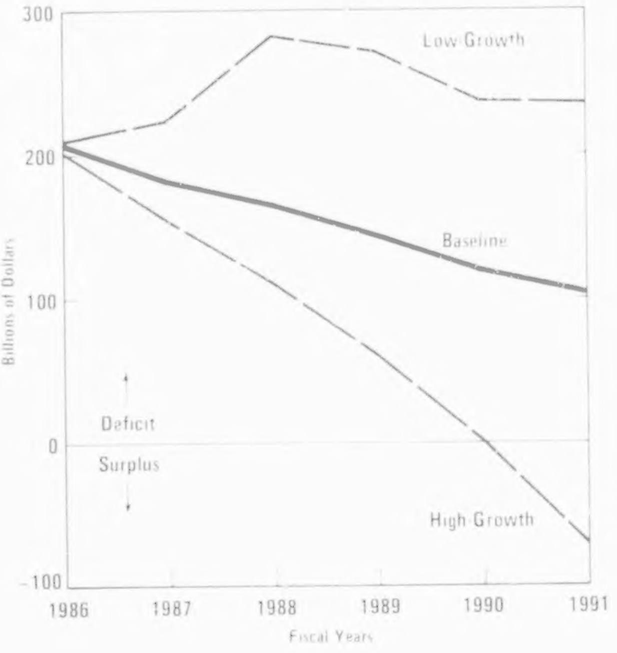
than in the baseline. Defense and nondefense appropriations are about the same as the baseline in the first few years but lower after 1988, reflecting less inflation. The lower inflation also tends to reduce entitlement spending, but the increase in the unemployment rate works in the opposite direction. On balance, entitlement spending in the low-growth case is above the baseline for the first few years, when the unemployment effect predominates, but below the baseline in 1990 and 1991, when the inflation effect is more powerful. Net interest is higher in all years--initially because of higher interest rates and later, as interest rates drop, because of higher deficits. Total spending in the low-growth case is above the baseline through 1989 and only slightly below the baseline thereafter. As a result, the deficit is considerably higher in all years.

Rules of Thumb

While the use of consistent alternative forecasts is one way to illustrate the sensitivity of the budget to the economy, the same point may be made in a

Figure II-3.

Federal Deficit Under Alternative Economic Assumptions



SOURCE: Congressional Budget Office.

different fashion. Table II-6 provides some rough orders of magnitude, or rules of thumb, for gauging the effects on the baseline budget projections of changes in individual economic variables considered in isolation. Because CBO does not rely on rules of thumb for preparing its budget projections, they only approximate how the CBO baseline budget projections would change with such changes in the economic outlook.

TABLE II-6. EFFECTS ON CBO BASELINE BUDGET PROJECTIONS OF SELECTED CHANGES IN ECONOMIC ASSUMPTIONS
(By fiscal year, in billions of dollars)

Economic Variable	1986	1987	1988	1989	1990	1991
Real Growth: Effect of One Percentage-Point Higher Annual Rate Beginning January 1986						
Change in revenues	4	16	32	49	69	91
Change in outlays	-1	-3	-6	-12	-18	-26
Change in deficit	-5	-19	-38	-61	-88	-118
Unemployment: Effect of One Percentage-Point Lower Annual Rate Beginning January 1986						
Change in revenues	23	37	36	37	39	41
Change in outlays	-3	-7	-11	-15	-19	-22
Change in deficit	-26	-44	-48	-52	-57	-63
Interest Rates: Effect of One Percentage-Point Higher Annual Rates Beginning January 1986						
Change in revenues	a/	1	1	1	1	1
Changes in outlays	3	10	16	19	23	27
Change in deficit	3	9	15	18	22	25
Inflation: Effect of One Percentage-Point Higher Annual Rate Beginning January 1986						
Change in revenues	5	15	27	39	52	68
Change in outlays	3	14	27	39	52	65
Change in deficit	-2	-1	a/	-1	a/	-3

SOURCE: Congressional Budget Office.

a. Less than $500 million.

The rules of thumb illustrate the budgetary effects of a one percentage-point change, beginning in January 1986, for four variables: real economic growth, unemployment, interest rates, and inflation. The rules of thumb show that:

- An increase in the real growth rate or a drop in the unemployment rate will increase revenues and decrease outlays and the deficit.
- An increase in interest rates, assuming no change in inflation or GNP, will raise outlays and the deficit by about the same amount and will have only a small positive effect on revenues.
- Assuming that discretionary spending and interest rates respond to inflation, an increase in inflation will raise outlays and revenues almost equally and, therefore, have little effect on the deficit. If discretionary appropriations were not adjusted for the increased inflation, the deficit would be $4 billion lower in 1987 and $30 billion lower in 1991.

The estimates shown in Table II-6 are similar to those published by CBO in its last two annual reports (*Baseline Budget Projections for Fiscal Years 1985-1989*, pp. 55-68, and *The Economic and Budget Outlook: Fiscal Years 1986-1990*, pp. 73-76). The reader is referred to those earlier volumes for a discussion of the assumptions, implications, and limitations of these rules of thumb.

SPENDING PROJECTIONS BY MAJOR CATEGORY

Baseline outlays are projected to grow by $262 billion, or 4.8 percent annually, over the 1986-1991 period. Relative to the size of the economy, however, both total spending and all its major components decline. Total outlays fall from 23.5 percent of GNP in 1986 to 20.6 percent in 1991 (see Table II-7).

National Defense

National defense programs include not only the military activities of the Department of Defense but also the nuclear weapons programs of the Department of Energy and miscellaneous activities, such as maintaining defense stockpiles and administering the Selective Service. The projected decline in national defense spending as a share of GNP is in sharp contrast with recent CBO baseline projections. CBO's August 1985 baseline assumed the budget authority figures for defense contained in the Congressional budget resolution for fiscal year 1985, adopted in September 1984. That resolution provided for about 5 percent real growth over the 1985 appropriation. As a result, the August baseline projected that defense outlays would rise each year relative to GNP and reach 7.6 percent by 1990.

TABLE II-7 CBO BASELINE OUTLAY PROJECTIONS FOR MAJOR SPENDING CATEGORIES (By fiscal year)

Major Category	1985 Actual	1986 Base	Projections 1987	1988	1989	1990	1991
			In Billions of Dollars				
National Defense	252.7	269.5	284.0	296.4	310.9	326.9	343.9
Entitlements and Other Mandatory Spending	440.2	453.7	473.6	509.0	536.4	566.5	604.1
Nondefense Discretionary Spending	172.1	173.2	174.3	182.6	188.3	195.9	204.0
Net Interest	129.4	138.6	145.0	154.4	157.6	159.1	160.3
Offsetting Receipts	-48.1	-48.8	-51.5	-56.4	-58.4	-60.7	-64.4
Total Outlays	946.3	986.1	1,025.3	1,085.9	1,134.9	1,187.6	1,247.9
On-Budget Outlays	769.5	801.7	827.0	875.7	912.9	952.8	998.5
Off-Budget Outlays	176.8	184.4	198.3	210.2	221.9	234.9	249.4
			As a Percent of GNP				
National Defense	6.4	6.4	6.3	6.1	6.0	5.8	5.7
Entitlements and Other Mandatory Spending	11.2	10.8	10.5	10.5	10.3	10.1	10.0
Nondefense Discretionary Spending	4.4	4.1	3.9	3.8	3.6	3.5	3.4
Net Interest	3.3	3.3	3.2	3.2	3.0	2.8	2.7
Offsetting Receipts	-1.2	-1.2	-1.1	-1.2	-1.1	-1.1	-1.1
Total Outlays	24.0	23.5	22.8	22.4	21.8	21.1	20.6
On-Budget Outlays	19.5	19.1	18.4	18.1	17.5	17.0	16.5
Off-Budget Outlays	4.5	4.4	4.4	4.3	4.3	4.2	4.1

SOURCE: Congressional Budget Office.

In the present projections, which assume no real growth in defense budget authority over the 1986 program level, the defense share of GNP hits a maximum of 6.4 percent in 1985 and 1986 and then drops. By 1991, under these assumptions, the ratio of defense to GNP would be 5.7 percent--less than in fiscal year 1982--as Figure II-4 illustrates.

Entitlements and Other Mandatory Spending

An entitlement program is one that provides benefits to any person, business, or unit of government that meets the established eligibility requirements. Authorization for entitlements constitutes a binding obligation of the federal government, and eligible recipients have legal recourse if the obligation is not met. In addition, as described in Appendix A, other permanent appropriations and certain annually appropriated accounts are treated as mandatory even though the House and Senate Budget Committees do not both consider them entitlements.

Table II-8 divides entitlement and mandatory spending into two broad categories--means-tested and nonmeans-tested programs. The means-tested category comprises programs that provide cash benefits or services to low-income people. These programs represent about 15 percent of entitlement outlays--$69.5 billion in 1986 and $85.9 billion in 1991. The largest and most rapidly growing program in the category is Medicaid, with outlays of $24.4 billion in 1986 and $33.5 billion in 1991. Other means-tested programs include Food Stamps, assistance payments, and Supplemental Security Income.

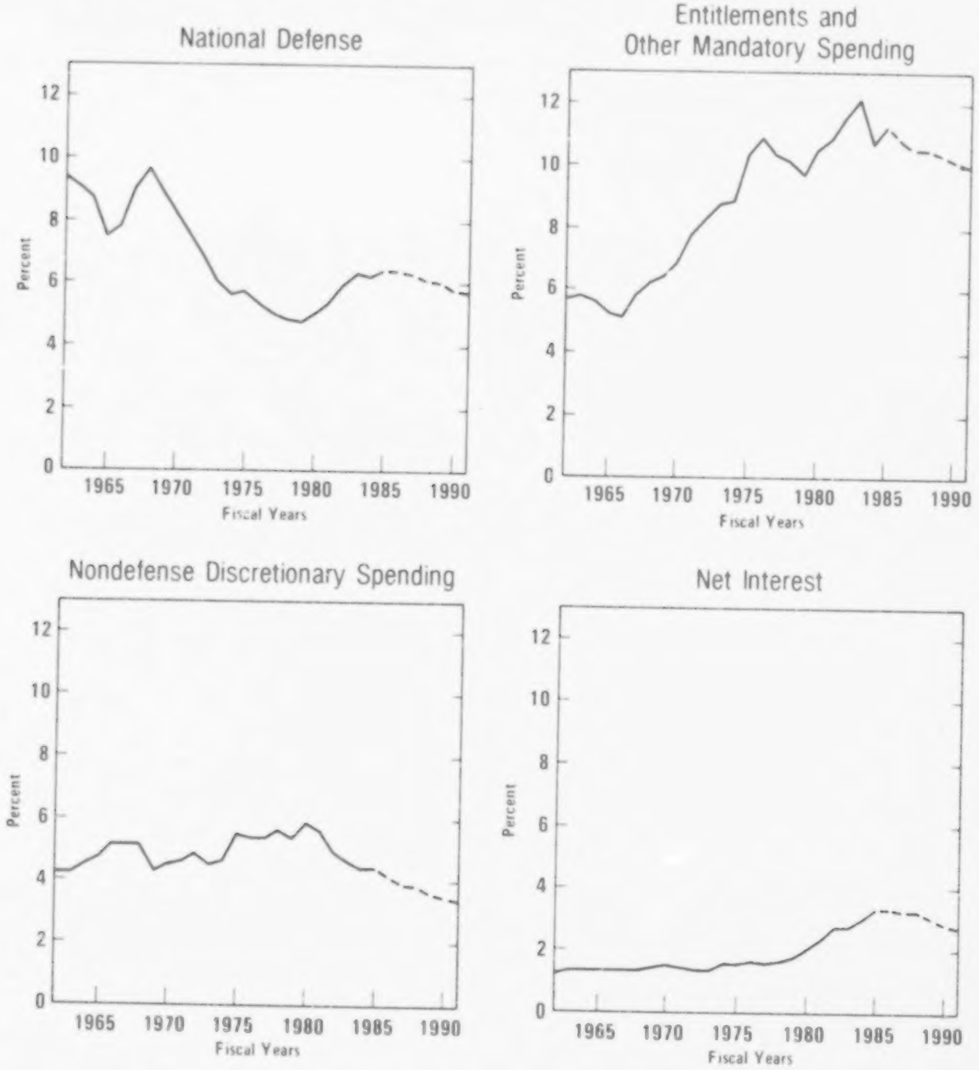
Nonmeans-tested programs can be subdivided into Social Security and Medicare, other retirement and disability programs, unemployment compensation, and other entitlement programs. Social Security and Medicare alone account for $269.8 billion, or almost 60 percent of entitlement spending in 1986; by 1991 they grow to $399.1 billion, or two-thirds of the entitlement total. Other retirement and disability programs, primarily federal civilian and military retirement, constitute 10 percent of entitlements. Unemployment compensation and other entitlements shrink from 15 percent to 9 percent of the total over the next five years.

Nondefense Discretionary Spending

Nondefense discretionary spending covers all remaining discretionary programs subject to annual appropriations or to loan or obligation limits imposed in appropriation acts. It includes portions of all budget functions

Figure II-4.

Outlays by Category as Percents of GNP



National Defense

Entitlements and Other Mandatory Spending

Nondefense Discretionary Spending

Net Interest

SOURCE: Congressional Budget Office.

TABLE II-8 CBO BASELINE OUTLAY PROJECTIONS FOR ENTITLEMENTS AND OTHER MANDATORY SPENDING (By fiscal year, in billions of dollars)

	1985 Actual	1986 Base	Projections 1987	1988	1989	1990	1991
Means-Tested Programs							
Medicaid	22.7	24.4	26.0	27.8	29.6	31.4	33.5
Food stamps	11.7	11.8	12.2	12.7	13.2	13.7	14.3
Supplemental Security Income	9.6	10.2	10.5	11.7	11.4	11.0	12.5
Assistance payments	8.6	9.2	9.5	9.8	10.0	10.3	10.8
Veterans' pensions	3.8	3.8	3.8	3.7	3.7	3.7	3.6
Child nutrition	3.7	3.9	4.2	4.5	4.8	5.1	5.4
Guaranteed student loans	3.5	3.4	3.4	3.4	3.3	3.1	3.0
Other	2.7	2.7	2.8	2.8	2.8	2.8	2.9
Total, Means-Tested Programs	66.3	69.5	72.3	76.4	78.8	81.5	85.9
Nonmeans-Tested Programs							
Social Security	186.5	197.3	209.3	223.9	239.3	255.7	273.4
Medicare	69.8	72.5	80.2	90.1	100.7	112.5	125.7
Subtotal	256.3	269.8	289.5	314.0	339.9	368.2	399.1
Other Retirement and Disability							
Federal civilian a/	23.1	24.1	25.4	27.2	29.0	31.0	33.1
Military	15.8	17.6	18.3	19.4	20.6	21.8	23.0
Other	5.2	5.1	5.3	5.5	5.6	5.8	6.0
Subtotal	44.0	46.8	49.0	52.0	55.3	58.6	62.1
Unemployment Compensation	17.5	16.4	16.7	16.9	17.0	17.0	17.5
Other Programs							
Veterans' benefits b/	12.9	13.1	13.3	13.6	13.5	13.5	13.8
Farm price supports	17.8	24.7	18.3	20.7	17.5	13.0	10.6
General revenue sharing	4.6	4.4	4.2	4.6	4.6	4.6	4.6
Social services	3.5	4.0	4.3	4.3	4.4	4.5	4.6
Other	17.3	4.9	6.0	6.4	5.5	5.9	5.9
Subtotal	56.0	51.1	46.0	49.6	45.4	41.4	39.5
Total, Non-Means-Tested Programs	373.9	384.2	401.2	432.5	457.6	485.3	518.1
Total Outlays	440.2	453.7	473.6	509.0	536.4	566.5	604.1

SOURCE: Congressional Budget Office.

a. Includes Coast Guard retirement.

b. Includes veterans' compensation, readjustment benefits, life insurance, and housing programs.

except national defense, net interest, and undistributed offsetting receipts. A large part of this category represents the salary and expense accounts that finance the ongoing operations of the civilian agencies of the federal government; this includes the legislative, judicial, and tax-collecting functions, the conduct of foreign affairs, and the costs of administering Social Security and Medicare. This category also covers most grants to state and local governments, including those for subsidized housing, highways and mass transit, elementary and secondary education, employment and training assistance, and low-income energy assistance. Nondefense discretionary spending, which already has declined to about the same share of GNP as it represented in 1962, falls further throughout the projections period to 3.4 percent of GNP in 1991.

Net Interest

The net interest category principally represents interest costs on federal debt held by the public, including that held by the Federal Reserve System. Interest paid to government trust funds has no effect on net interest outlays, since it is counted both as an expenditure and a receipt. Net interest costs are very sensitive to the assumptions made about future deficits and interest rates. A sustained one percentage-point rise in all interest rates would cause net interest outlays to exceed the baseline by $3 billion in 1986, $10 billion in 1987, and $26 billion in 1991. An increase in the deficit of $10 billion in each fiscal year during the 1986-1991 period would cause net interest to rise by $300 million in 1986, $1.4 billion in 1987, and $5.0 billion in 1991.

Because of declining deficits and interest rates (which are predicated on reaching the deficit targets in the Balanced Budget Act), the baseline projections reflect a slowing in the rate of growth of net interest. As a share of GNP, net interest declines from its 1985-1986 peak of 3.3 percent to 2.7 percent in 1991. Debt held by the public also grows more slowly (see Box II-2 on federal government borrowing and debt) and begins to decline as a percent of GNP after 1988 (as shown in Table II-1). Debt subject to statutory limit will reach its current ceiling of $2,078.7 billion in September 1986.

Offsetting Receipts

Offsetting receipts comprise federal government proprietary receipts from the public that are substracted from outlays rather than included in reve-

BOX II-2

FEDERAL GOVERNMENT BORROWING AND DEBT

The federal government borrows to finance its total deficit--the on-budget deficit less the off-budget surplus. Debt held by the public is the federal government's cumulative borrowing over the years from individuals, banks, and other private investors (including the Federal Reserve System). Each year debt held by the public grows by the amount of the total deficit, with small adjustments for changes in cash balances and other means of financing.

Debt held by government accounts represents holdings of debt by federal government trust funds and other special funds. These holdings grow as the trust funds run surpluses, which are invested in special interest-bearing Treasury securities. The surpluses of the off-budget Social Security trust funds (as well as those of the on-budget trust funds) thus reduce the need to borrow from the public but increase the debt held by government accounts by an equal amount and do not affect gross government debt. The trust funds' debt holdings represent their future claim on the government's cash when the funds' earmarked receipts may--for short or long periods--fall below their spending.

Debt subject to statutory limit is the figure voted by the Congress when raising the federal government's debt issuance authority. It differs from the gross federal debt in excluding a small amount of agency and other debt.

(In billions of dollars)

	1985	1986	1987	1988	1989	1990	1991
Total Deficit	212	208	181	165	144	120	104
Other Means of Financing	15	-2	1	1	1	1	1
Borrowing from the Public	197	210	180	164	143	119	103
Gross Federal Debt							
Held by the public	1,510	1,720	1,900	2,064	2,207	2,326	2,429
Held by government accounts	318	394	461	543	635	744	864
Total	1,827	2,114	2,362	2,607	2,842	3,070	3,293
Debt Subject to Statutory Limit	1,824	2,110	2,358	2,604	2,838	3,067	3,290

nues, as well as certain intragovernmental transactions. Of the $48.8 billion estimated in this category for 1986, $29.1 billion is the federal employer share of employee retirement. Another $5.8 billion consists of premiums paid by enrollees in Supplementary Medical Insurance (Medicare Part B) and by those who do not have sufficient quarters of coverage for Hospital Insurance (Medicare Part A). The next largest item, $5.1 billion, is rents and royalties for leases on Outer Continental Shelf tracts. Other receipts are for the sale or lease of minerals, electric power, and timber. Offsetting receipts are projected to represent 1.1 percent to 1.2 percent of GNP in all years.

REVENUE PROJECTIONS BY MAJOR SOURCE

Baseline revenues (including off-budget revenues) are projected to keep pace with GNP in 1986, increasing by $43.8 billion to $777.8 billion, while remaining at 18.6 percent of GNP. Revenue growth is projected to outpace the economy in 1987 and 1988. Revenues will reach $844.0 billion in 1987, or 18.7 percent of GNP, and $921.0 billion in 1988, or 19.0 percent of GNP. From 1988 through 1991, revenues are projected to grow somewhat more slowly than the economy, totaling $1,143.6 billion, or 18.9 percent of GNP in 1991 (see Table II-9). With only minor changes in economic assumptions and no major new legislation, revised baseline revenues will claim almost the same share of GNP at the end of the projection period as did CBO's projected baseline revenues in August 1985.

The pickup in baseline revenue growth in 1987 reflects the delayed effect of strong corporate profit increases in 1986. Individual income taxes grow slightly faster than the economy throughout the 1987-1991 period, because increases in real earnings push taxpayers into higher tax rate brackets. The 0.72 percentage-point increase in combined employer-employee Social Security tax rates effective in January 1988 underlies the strong revenue growth in 1988. Only personal income and Social Security taxes keep pace with GNP after 1988. By 1991 revenues as a whole grow a bit more slowly than GNP. Personal taxes account for an unprecedented 84 percent of total revenues in 1991, with the share of other taxes continuing to fall below previous levels (see Figure II-5).

BASELINE CREDIT PROJECTIONS

The credit baseline shows the level of new direct loan obligations and primary loan guarantee commitments that, like the baselines for federal spending and revenues, would occur with the continuation of current policies. These credit activities are not accurately measured by the outlay totals discussed previously, which include only loan disbursements net of any repayments and guarantees in the event of default. Consequently, they must be separately measured and analyzed.

TABLE II-9. BASELINE REVENUE PROJECTIONS BY SOURCE (By fiscal year)

Major Source	1985 Actual	1986 Base	Projections 1987	1988	1989	1990	1991
			In Billions of Dollars				
Individual Income	334.5	354.4	384.7	421.8	460.7	500.7	543.0
Corporate Income	61.3	72.2	89.2	100.2	108.0	112.2	113.9
Social Insurance	265.2	280.8	300.9	331.7	355.0	385.2	415.3
Windfall Profit	6.3	4.2	2.0	1.6	1.6	1.5	1.4
Other Excises	29.7	29.1	28.6	27.6	27.2	27.8	28.7
Estate & Gift	6.4	6.1	5.6	5.4	5.1	5.4	5.8
Customs Duties	12.1	12.3	13.6	14.9	15.9	16.9	18.1
Miscellaneous	18.5	18.7	19.4	17.8	17.8	17.7	17.5
Total Revenues	734.1	777.8	844.0	921.0	991.3	1,067.5	1,143.6
On-Budget Revenues	547.9	579.5	630.6	680.3	730.2	780.8	831.7
Off-Budget Revenues	186.2	198.3	213.4	240.7	261.2	286.7	312.0
			As Percents of GNP				
Individual Income	8.5	8.5	8.5	8.7	8.8	8.9	9.0
Corporate Income	1.6	1.7	2.0	2.1	2.1	2.0	1.9
Social Insurance	6.7	6.7	6.7	6.9	6.8	6.9	6.9
Windfall Profit	0.2	0.1	a/	a/	a/	a/	a/
Other Excises	0.8	0.7	0.6	0.6	0.5	0.5	0.5
Estate & Gift	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Customs Duties	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Miscellaneous	0.5	0.4	0.4	0.4	0.3	0.3	0.3
Total Revenues	18.6	18.6	18.7	19.0	19.0	19.0	18.9
On-Budget Revenues	13.9	13.8	14.0	14.1	14.0	13.9	13.8
Off-Budget Revenues	4.7	4.7	4.7	5.0	5.0	5.1	5.2

SOURCE: Congressional Budget Office.

a. Less than 0.05 percent.

Credit activity is projected from the limits set in fiscal year 1986, as reduced by the Balanced Budget Act. From this base, loan obligations or commitments for the 1987-1991 period are generally projected to grow at the rate of inflation. For credit programs without appropriation limits, the projections represent CBO's best estimate of loan activity.

Under these baseline assumptions, CBO projects that annual total federal credit activity will decrease from a 1986 base of $138 billion in new direct loan obligations and new primary loan guarantee commitments to

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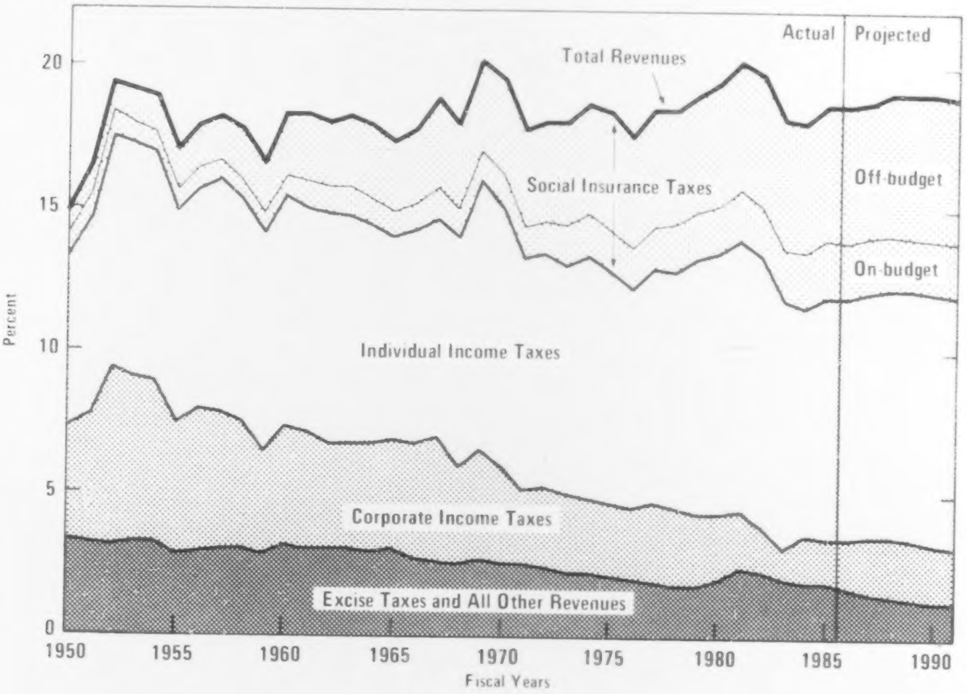
Figure II-5.
Revenues by Source as Percents of GNP



SOURCE: Congressional Budget Office.

$126 billion in 1987, and then grow slowly to $132 billion in 1991 (see Table II-10). The major factor in the decrease between 1986 and 1987 is a drop of $12 billion in primary guarantee commitments by the Federal Housing Administration (FHA). From 1986 through 1991, new direct loan obligations are expected to fall from $43 billion to $34 billion, or about 20 percent. The major areas of reduction are the CCC commodity price support loans and Farmer's Home Administration loan programs. Primary loan guarantee commitments will grow from $94 billion in 1986 to $98 billion in 1991, an increase of 4 percent. Secondary guarantees of the Government National Mortgage Association and the Trade Credit Insurance Fund grow from $55 billion in 1986 to $67 billion in 1991, an increase of 22 percent.

For both direct and guaranteed loans, five budget functions predominate in the totals (see Appendix Table B-3). Direct loans are made mainly for agriculture, commerce and housing, international affairs, veterans' affairs, and education. Housing loan guarantees made by the VA and FHA themselves comprise over 60 percent of total guarantees in any year.

The Balanced Budget Act integrated credit activity into the budget process and made credit activity subject to the act's sequestration orders. While the credit totals shown in Table II-10 better reflect the new lending

TABLE II-10. CBO BASELINE CREDIT PROJECTIONS
(By fiscal year, in billions of dollars)

Credit Activity	1985 Actual	1986 Base	Projections 1987	1988	1989	1990	1991
Net Direct Loan Obligations	52.8	42.8	37.5	36.1	35.1	34.1	33.9
Primary Loan Guarantees	84.7	94.4	88.1	91.6	94.7	97.9	97.6
Total	137.5	137.2	125.6	127.7	129.8	132.0	131.5
Secondary Guarantees	54.6	55.3	57.5	59.9	62.3	64.6	67.3

SOURCE: Congressional Budget Office.

activity than do budget outlays, neither the credit budget nor the spending budget adequately measures the economic significance of credit transactions. A better indicator would be the effective loan subsidies provided in any year. For direct loans, the subsidy is the difference between rates charged borrowers on private and government loans that are comparable in other respects. For guarantees, the subsidy is the difference between the cost of the government's guarantee and the fee that would be charged by a private insurer.

CHAPTER III

AUTOMATIC SPENDING REDUCTIONS UNDER THE BALANCED BUDGET ACT

The Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177) establishes steadily declining deficit targets after 1986, culminating in a balanced budget in fiscal year 1991. The deficit target for fiscal year 1987 is $144 billion. Unless the Congress acts to reduce the deficit to this level before the start of the fiscal year, any excess deficit would be removed by sequestering budgetary resources. The deficit estimates used to implement the act are provided by the Congressional Budget Office (CBO), the Office of Management and Budget (OMB), and the General Accounting Office (GAO). Although the automatic spending reduction provision of the act has been ruled unconstitutional by a federal district court and this ruling may be upheld by the Supreme Court, the sequestration of budgetary resources to achieve deficit targets would remain an option to be used by the Congress under alternative procedures.

Given CBO's February assumptions, total outlays under a 1987 sequestration would have to be reduced to approximately $989 billion, or $37 billion below CBO's baseline estimate. There would be almost no growth in nominal outlay levels beyond CBO's postsequestration 1986 baseline level of $986 billion. For defense programs, new budget authority for 1987 would be limited to $271 billion, which is $30 billion below CBO's baseline projection and $49 billion below the Administration's budget request.

The sequestration procedures for 1987 will begin in August when the CBO and OMB will make their initial budget estimates, either to the Comptroller General or to a special joint committee of the Congress. The CBO estimates presented in this chapter are made for illustrative purposes and are subject to significant revision over the next six months as the result of legislative actions, changes in the economic outlook, and other factors. These estimates show that relying on the sequestration procedures to reach the $144 billion deficit amount specified for 1987 would mean reductions of $18 billion in outlays for defense programs and $17 billion for nondefense programs from CBO projected baseline levels. To achieve these outlay results, defense appropriations for 1987 would have to be reduced by 6.2 percent below 1986 postsequestration levels, and nondefense discretionary appropriations would have to be cut by 8.4 percent. The reductions in real terms would be even greater because of the loss of any adjustments for inflation in 1987.

PROVISIONS OF THE BALANCED BUDGET ACT

The Balanced Budget Act stipulates that budget deficits must be decreased annually and specifies measures that must be taken to achieve this result. The maximum deficit amounts set by the act for fiscal years 1986 to 1991 are (in billions of dollars):

Fiscal Year	Maximum Deficit
1986	171.9
1987	144.0
1988	108.0
1989	72.0
1990	36.0
1991	zero

If the deficit is estimated to exceed the maximum level by any amount in 1986 and 1991, or by more than $10 billion in 1987 through 1990, an automatic spending reduction procedure is triggered to eliminate the excess deficit through the sequestration of budgetary resources. Except for trust and special funds, this involves the permanent cancellation of new budget authority and other authority to obligate and expend funds. For 1986, the outlay reduction is limited by the act to a maximum of $11.7 billion, regardless of the amount of the excess deficit. In later years, the amount of possible outlay reductions is not limited.

The first step in the sequestration process is a joint report by the Director of the Office of Management and Budget and the Director of the Congressional Budget Office to the Comptroller General that:

- Estimates budget base levels, including the amount by which the projected deficit exceeds the maximum deficit amount for the fiscal year covered by the report;

- Provides OMB and CBO economic assumptions, including the estimated rate of real economic growth; and

- Calculates the amounts and percentages by which various budgetary resources must be sequestered in order to eliminate any deficit excess.

If either CBO or OMB projects real economic growth to be less than zero for any two consecutive quarters, or if the Department of Commerce reports actual real growth to be less than 1 percent for two consecutive quarters, many of the provisions of the Balanced Budget Act can be suspended by the Congress, including a sequestration order if it has not already gone into effect.

For fiscal year 1986, the joint OMB/CBO report to the Comptroller General was made on January 15, 1986, and was published in the *Federal Register* on that date. For subsequent years, the Directors will make an initial report on August 20 and a revised report on October 5 to reflect final Congressional action on the budget during the month of September.

The Comptroller General reviews the Directors' reports and issues his own reports to the President and the Congress that confirm or modify the information reported by OMB and CBO. The Comptroller General's reports are the basis for reductions in budgetary resources to be ordered by the President. For fiscal year 1986, the Comptroller General's report to the President was made on January 21, 1986, and was published in the *Federal Register*. For subsequent years, his initial report will be made on August 25 and the revised report on October 10.

The Presidential order to sequester funds specified by the Comptroller General was issued on February 1 for 1986 and will be issued on September 1 for subsequent years. Unless the Congress acts--and the President agrees--to modify the sequestration results by adopting an alternative plan to reduce the deficit, the 1986 reductions will take effect March 1, 1986, and the 1987-1991 reductions on October 1 in those years. Any Congressional action taken during September to reduce excess deficits for 1987 through 1991 will be reflected in a final Presidential order to be issued on October 15.

The constitutionality of the Balanced Budget Act procedures is now under review by the Supreme Court. The District Court for the District of Columbia ruled on February 7 that the role played by the Comptroller General in the sequestration procedures was unconstitutional because the act vests executive power in an officer who can be removed by the Congress. If the Supreme Court upholds the view of the district court, an alternative set of procedures would go into effect. The joint report by the Directors of CBO and OMB would be transmitted to a joint committee of the Congress made up of the entire membership of the House and Senate Budget Committees. This joint committee will report the contents of the CBO/OMB sequestration report in the form of a joint resolution to be passed by both Houses and approved by the President. Upon enactment of the joint resolution, the sequestration of budgetary resources would proceed.

This chapter gives a preview of the August 1986 CBO/OMB report to the Comptroller General or to the joint Budget Committee for fiscal year 1987. The calculations of amounts to be sequestered presented in this chapter use the CBO baseline and alternative economic assumptions discussed in Chapter I, and the baseline budget projections discussed in Chapter II. The August sequestration report will differ to the extent that there are legislative actions during the next six months that affect revenues or outlays, or that there are changes in the economic outlook or in other factors affecting budget estimates. In addition, the August report will use the average of CBO and OMB estimates of key amounts instead of relying solely on the CBO estimates used here for illustrative purposes.

BUDGET BASE LEVELS FOR 1987

The budget base levels of federal revenues and outlays determine the size of the excess deficit and, thus, the amount by which spending must be reduced under the emergency deficit reduction procedures mandated by the Balanced Budget Act. The budget base level estimates are, therefore, a key ingredient in the sequestration calculations.

The act provides that the base be calculated on a somewhat different basis than is used for the CBO baseline projections. The revenue level in the budget base is to be estimated on the assumption that current tax laws continue unchanged, and that expiring provisions will terminate as scheduled except for excise taxes dedicated to a trust fund, which are to be extended at current rates. The outlay level for entitlements or permanent appropriations is also to assume continuation of current law and termination of expiring provisions, except for Commodity Credit Corporation (CCC) price-support programs, which are to be extended at current rates. For annual discretionary appropriations, the outlay base estimates are to include enacted appropriation levels. If appropriations for the fiscal year have not been enacted five days or more before the CBO/OMB reporting dates, the outlay base estimates are to assume appropriations equal to those in force for the previous year with no adjustments for inflation.

CBO estimates of 1987 budget base levels are shown in Table III-1. The base level deficit for a possible 1987 sequestration is estimated at $166.6 billion, using CBO's February economic forecast. Under high-growth alternative economic assumptions, the base level deficit falls to $138.7 billion, which is about $5 billion below the maximum deficit amount specified for 1987. Under these assumptions, the emergency deficit reduction procedures would not be invoked. On the other hand, the base level deficit would climb to $208.1 billion under CBO's low-growth assumptions. These assumptions, however, include a recession in 1987, so that the Congress would have the option of suspending the sequestration procedures.

Changes from Baseline Budget Projections

The 1987 budget base levels shown in Table III-1 include a number of changes from the CBO baseline budget projections discussed in Chapter II. First, they assume termination of expiring provisions of law that were assumed to be extended for the CBO baseline projections. The major item is general revenue sharing, which will terminate at the end of fiscal year 1986 unless the current law is extended. Also, the temporary reduction in federal employees' retirement fund contributions will expire on April 30, 1986. This reduction was assumed to be extended for the CBO baseline projections.

Second, the budget base level estimates for outlays exclude discretionary inflation and other adjustments made to 1986 postsequestration appropriation levels for the CBO baseline projections. These adjustments were made in the CBO baseline to keep program levels constant in real terms, but they would not be included for sequestration calculations. The outlay estimates include proposed pay increases for military and federal civilian employees contained in the President's budget for 1987, which differ somewhat from the CBO baseline assumptions. Finally, net interest costs are adjusted to reflect the changed deficit levels in the budget base. These changes in CBO baseline budget projections are summarized in Table III-2.

TABLE III-1. BUDGET BASE LEVELS FOR THE 1987 SEQUESTRATION UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS
(In billions of dollars)

Budget Aggregates	CBO February Forecast	High-Growth Alternative	Low-Growth Alternative
Revenues	844.6	866.4	818.2
Outlays	1,011.2	1,005.1	1,026.3
Deficit	166.6	138.7	208.1

SOURCE: Congressional Budget Office.

Base Level Outlay Estimates

Further detail on the CBO base level outlay estimates for 1987 are provided in Table III-3, which shows that a relatively small portion of 1987 outlays will be affected by the sequestration of budgetary resources. About $172 billion of estimated 1987 outlays for defense programs, or 62 percent of total defense outlays, is associated with budgetary resources subject to an across-the-board percentage reduction. This amount includes $67 billion for military personnel accounts. The special exemption for military personnel accounts made by the President for 1986 will not be permitted in 1987 under the Balanced Budget Act. Outlays for military retirement benefits are included in the nondefense spending category.

TABLE III-2. CHANGES IN CBO BASELINE BUDGET PROJECTIONS TO CALCULATE BUDGET BASE LEVELS FOR SEQUESTRATION (In billions of dollars)

Item	Revenues	Outlays	Deficit
CBO Baseline Projections a/	844.0	1,025.3	181.3
Changes:			
Assume termination of expiring provisions of law:			
General revenue sharing	---	-3.4	-3.4
Federal employee retirement adjustment	0.6	---	-0.6
Exclude discretionary inflation and other adjustments to 1986 appropriation (postsequestration) levels:			
Defense programs	---	-7.5	-7.5
Nondefense programs	---	-2.6	-2.6
Adjust net interest costs	---	-0.6	-0.6
Total changes	0.6	-14.1	-14.7
Budget Base Levels a/	844.6	1,011.2	166.6

SOURCE: Congressional Budget Office.

a. Calculated using the CBO February economic forecast discussed in Chapter I.

TABLE III-3. BASE LEVEL OUTLAY ESTIMATES FOR THE 1987 SEQUESTRATION

Category	Billions of Dollars	Percent
Defense Programs a/		
Subject to across-the-board reduction	171.9	17.0
Other b/	104.6	10.3
Subtotal, defense programs	276.5	27.3
Nondefense Programs		
Programs with automatic spending increases c/	50.3	5.0
Certain special rule programs d/	96.2	9.5
Subject to across-the-board reduction	100.3	9.9
Major exempt programs		
Social Security and Railroad Retirement Tier 1	210.2	20.8
Net interest	144.4	14.3
Earned Income Tax Credit	1.2	0.1
Low-income programs e/	64.9	6.4
Veterans' compensation and pensions	14.4	1.4
State unemployment benefits	15.0	1.5
Offsetting receipts	-52.1	-5.2
Other f/	90.0	8.9
Subtotal, nondefense programs	734.7	72.7
Total	1,011.2	100.0

SOURCE: Congressional Budget Office.

a. Budget function 050, national defense.

b. Outlays from obligated balances.

c. Primarily federal employee retirement and disability programs, including military retirement.

d. Guaranteed student loans, foster care and adoption assistance, Medicare, veterans' medical care, community health, migrant health, and Indian health.

e. Aid to Families with Dependent Children, child nutrition, Medicaid, Food Stamps, Supplemental Security Income, and the Supplemental Feeding Program for Women, Infants, and Children.

f. Outlays from prior-year appropriations, certain prior legal obligations, and small exempt programs.

About $247 billion, or one-third of estimated outlays for nondefense programs, are associated with sequestrable budgetary resources. Of this total, $50 billion is for programs with automatic spending increases, primarily military and federal civilian employee retirement and disability programs. For these programs, the amount of spending reduction required by the act is limited to the cost-of-living adjustments, which are projected generally to be 3.4 percent for 1987. Another $96 billion in nondefense outlays is associated with certain special rule programs, of which the largest is Medicare. The act also limits the extent of spending reductions for these programs to not more than 2 percent in 1987 and future years.

Only $100 billion in 1987 nondefense outlays--about 14 percent--is associated with budgetary resources subject to an across-the-board percentage reduction. About $400 billion, or more than one-half of total estimated outlays for nondefense programs, is exempted from sequestration by the act. As shown in Table III-3, these exempt outlays are mostly for Social Security benefits and net interest costs.

CALCULATIONS FOR THE ILLUSTRATIVE 1987 SEQUESTRATION

The major elements of calculations for the illustrative 1987 sequestration, using CBO's February economic assumptions, are shown in Table III-4. Although the sequestration actually applies to new budget authority and other spending authority, the calculations use outlay estimates to determine the amount of sequestration.

The first step is to divide the amount of excess deficit--$22.6 billion for 1987--into two halves. One-half--$11.3 billion--is assigned to defense programs (budget accounts in function 050) and the other half to nondefense programs.

Second, the total amount of outlay savings from eliminating automatic spending increases is calculated. One-half of the resulting savings for indexed retirement and disability programs is applied to the required reduction in defense programs and one-half to nondefense programs. This amounts to an estimated $1.2 billion for 1987, so that $0.6 billion is subtracted from the $11.3 billion required reduction for both defense and nondefense programs.

Various additional calculations are made for nondefense programs, including the savings that can be obtained by eliminating automatic spending increases in three other specific programs--the National Wool Act, the special milk program, and vocational rehabilitation grants. Also included are savings to be obtained by applying certain special rules for guaranteed student loans, foster care and adoption assistance, Medicare, and certain health programs. These estimated savings amount to another $1.5 billion, which is also subtracted from the required reduction of $11.3 billion in nondefense outlays.

This leaves $10.7 billion for defense programs and $9.2 billion for nondefense programs to be obtained by across-the-board uniform percentage reductions in budgetary resources. The uniform percentages are calculated by dividing these dollar amounts by total estimated 1987 outlays associated

TABLE III-4. CALCULATING THE ILLUSTRATIVE SEQUESTRATION FOR 1987 (Outlays in billions of dollars)

Sequestration Items	Defense Programs	Nondefense Programs
Total Required Reductions	11.3	11.3
Savings from Eliminating Automatic Spending Increases		
Indexed retirement and disability programs	0.6	0.6
Other indexed programs	---	a/
Savings Under Special Rules	---	1.5
Remaining Reduction Required	10.7	9.2
Sequestration Outlay Base	171.9	109.5 b/
Uniform Reduction Percentage c/	6.2	8.4

SOURCE: Congressional Budget Office.

a. Less than $50 million.

b. Includes $9.2 billion in estimated 1988 outlays for the Commodity Credit Corporation that can be affected by a 1987 sequestration.

c. Remaining required reductions divided by the sequestration outlay base.

with sequestrable budgetary resources. For defense programs, the sequestrable outlay base is $171.9 billion. For nondefense programs, the base is $109.5 billion, which includes $15.2 billion of 1988 outlays for farm price-support programs that can be affected by the 1987 sequestration. The resulting percentages are 6.2 percent for defense programs, and 8.4 percent for nondefense programs. These percentages are then applied to the new budget authority and other spending authority in the sequestration base.

As noted earlier, the budget base levels and calculations of the sequestration are very sensitive to changes in economic assumptions and other factors. For example, the base level deficit for a possible 1987 sequestration ranges from $139 billion to $208 billion under alternative economic assumptions, as shown in Table III-1. The likely deviation from the $167 billion base level deficit under CBO's February forecast caused by changes in the economic outlook between now and August should be smaller than indicated by this range, but could still be large.

Factors other than changes in the economic outlook can also affect significantly the estimates of outlays and the deficit. For example, the CBO estimates for 1986 outlays were increased by $16 billion between November 1985 and January 1986 because of Congressional actions and technical reestimates of spending. The largest change in 1986 outlay estimates was for agriculture programs, primarily CCC farm price-support programs. The farm bill passed in December added between $2 billion and $3 billion to estimated 1986 outlays, and lower farm commodity prices than assumed earlier led to a sharp upward revision in CBO spending estimates by $7 billion to $8 billion. Similar changes could be made in 1987 CCC outlay estimates in either direction between now and August, if unexpected changes occur in the size of harvests this summer or in farm exports. Another area where major technical reestimates of spending could be made is for defense programs. Reestimates on the order of $3 billion to $4 billion are not uncommon because of changes in spending rates observed in monthly Treasury statements.

For each $10 billion increase in the excess deficit, the uniform reduction percentage for defense programs is increased by about 3.0 percentage points, and for nondefense programs by about 4.5 percentage points, as shown in Table III-5. For example, if the August estimate of the base level deficit were $20 billion higher than the CBO February estimate of $166.6 billion because of such factors as lower revenues and higher interest rates, which do not change the sequestration base, the sequestration percentages would be 12.1 percent for defense programs and 17.5 percent for nondefense programs.

SEQUESTRATION RESULTS

The required reductions in spending authority of various types, which are summarized in Tables III-6 and III-7, assume a 1987 sequestration of 6.2 percent for defense programs and 8.4 percent for nondefense programs. For defense programs in budget function 050, the required reduction in spending authority (new budget authority and unobligated balances) would amount to $21.1 billion to achieve outlay savings of $10.7 billion. This defense outlay reduction is lower than one-half of the $22.6 billion required because the savings from eliminating automatic spending increases for federal retirement programs--including military retirement--are counted in the income security function and are shown in the nondefense savings table.

For nondefense programs, the required reduction in spending authority would amount to $35.8 billion to produce $11.9 billion in outlay savings. The spending authority includes new budget authority, new direct loan obligations, new loan guarantee commitments, obligation limitations, and other spending authority for 1987. The outlay savings include $0.8 billion in estimated 1988 outlay reductions for Commodity Credit Corporation farm

TABLE III-5. SEQUESTRATION PERCENTAGE REDUCTIONS UNDER ALTERNATIVE BASE LEVEL DEFICIT ESTIMATES FOR 1987 (In billions of dollars)

Base Level Deficit	Excess Deficit	Sequestration Percentage [a/] Defense Programs	 Nondefense Programs
194	50	14.2	20.9
184	40	11.3	16.3
174	30	8.4	11.8
164	20	5.5	7.2
154	10	2.6	2.6

SOURCE: Congressional Budget Office.

a. Assumes no changes in the sequestration outlay base for defense and nondefense programs from those shown in Table III-4, and no changes in the savings from eliminating automatic spending increases and from applying special rules for Medicare and other programs.

price-support programs, which would be credited toward a 1987 sequestration. In most instances, additional outlay savings will be gained in 1987 and later fiscal years as the result of eliminating the 1987 cost-of-living adjustments and canceling 1987 budget authority. These savings, however, have not been calculated for this report.

TABLE III-6. ILLUSTRATIVE SEQUESTRATION FOR DEFENSE PROGRAMS FOR 1987 (In billions of dollars)

Budget Function 050	Spending Authority a/	Estimated Outlays
Department of Defense--Military		
Military personnel	4.3	4.2
Operation and maintenance	4.7	3.7
Procurement	8.5	1.1
Research, development, test, and evaluation	2.2	1.2
Military construction	0.5	0.1
Family housing and other	0.3	0.2
Subtotal, DoD	20.5	10.4
Atomic Energy Defense Activities	0.5	0.3
Other Defense-related Activities b/	0.1	c/
Total	21.1	10.7

SOURCE: Congressional Budget Office.

NOTE: Calculated using the CBO February economic forecast for 1987.

a. Includes new budget authority for 1987 and unobligated balances from budget authority provided in previous years.

b. Includes the budget function 050 portion of Federal Emergency Management Agency budget accounts, which are reduced at the same rate as nondefense programs.

c. Less than $50 million.

TABLE III-7. ILLUSTRATIVE SEQUESTRATION FOR NONDEFENSE PROGRAMS FOR 1987 (In billions of dollars)

Budget Function		Spending Authority a/	Estimated Outlays
150	International Affairs	3.3	0.8
250	General Science, Space and Technology	0.8	0.5
270	Energy	1.2	0.3
300	Natural Resources and Environment	1.3	0.8
350	Agriculture	3.4	1.8b/
370	Commerce and Housing Credit	11.4c/	0.4
400	Transportation	3.5	0.8
450	Community and Regional Development	0.6	0.1
500	Education, Training, Employment, and Social Services	2.2	0.8
550	Health	0.9	0.6
570	Medicare	1.4	1.4
600	Income Security	2.7	1.8
650	Social Security	0.2	0.2
700	Veterans' Benefits and Services	1.4	0.4
750	Administration of Justice	0.6	0.5
800	General Government	0.5	0.5
850	General Purpose Fiscal Assistance	0.2	0.2
920	Allowances	0.1	0.1
	Total	35.8	11.9

SOURCE: Congressional Budget Office.

NOTE: Calculated using the CBO February economic forecast for 1987.

a. Includes new budget authority, new direct loan obligations, new loan guarantee commitments, obligation limitations, and other spending authority for 1987.

b. Includes $0.8 billion in estimated 1988 outlay savings for programs of the Commodity Credit Corporation.

c. Most of the sequestration is for new loan guarantee commitments for mortgage credit programs.

A sequestration of 6.2 percent for defense programs and 8.4 percent for nondefense programs for 1987 would be much more severe than these percentages imply. This is because calculations for the 1987 sequestration are based on 1986 postsequestration budget levels, with no adjustments for inflation or other factors. Combined with the 1986 sequestration percentage, the possible 1987 sequestration implies reductions from 1986 appropriation levels of 10.8 percent for defense programs and 12.3 percent for nondefense programs. The reduction in real terms would be even greater because of the loss of any adjustments for inflation in 1987.

The effect of sequestration on budget outlays for 1986 and 1987 is shown in Table III-8. The 1986 sequestration would lower total 1986 outlays

TABLE III-8. EFFECT OF SEQUESTRATION ON BUDGET OUTLAYS FOR 1986 AND 1987 (By fiscal year, in billions of dollars)

Category	1986	1987
National Defense a/		
CBO baseline excluding 1986 sequestration	275.0	293.1
CBO baseline including 1986 sequestration	269.5	284.0
1987 sequestration base level	269.5	276.5
1987 postsequestration level	269.5	265.9
Nondefense Programs b/		
CBO baseline excluding 1986 sequestration	618.1	639.4
CBO baseline including 1986 sequestration	612.2	632.2
1986 sequestration base level	612.2	626.3
1987 postsequestration level	612.2	615.2
Net Interest and Undistributed Offsetting Receipts c/		
CBO baseline excluding 1986 sequestration	104.8	110.8
CBO baseline including 1986 sequestration	104.5	109.1
1987 sequestration base level	104.5	108.4
1987 postsequestration level	104.5	107.5
Total Outlays		
CBO baseline excluding 1986 sequestration	997.9	1,043.3
CBO baseline including 1986 sequestration	986.1	1,025.3
1987 sequestration base level	986.1	1,011.2
1987 postsequestration level	986.1	988.6

SOURCE: Congressional Budget Office.

a. Budget function 050.

b. Budget functions 150 through 850 and 920.

c. Budget functions 900 and 950.

by $11.8 billion, from $997.9 billion to $986.1 billion. The 1986 sequestration also reduces CBO baseline outlays for 1987 by $18.0 billion, from $1,043.3 billion to $1,025.3 billion, because the sequestration of most budgetary resources is assumed to persist in later years. Another sequestration in 1987 of the size calculated by CBO would lower 1987 outlays by an additional $36.7 billion, to $988.6 billion. About $14.1 billion of this additional reduction represents eliminating the inflation and other adjustments to 1986 postsequestration levels made by CBO for its baseline projections. The remaining $22.6 billion is the size of the estimated excess deficit in 1987 using the Balanced Budget Act's specifications for estimating budget base levels. The effect of the possible 1987 sequestration would be to hold total outlays in that year to approximately the 1986 level.

The effects of sequestration on defense and nondefense program outlays are also shown in Table III-8. The 1986 sequestration reduces CBO baseline outlays for defense programs by $5.5 billion in 1986 and by $9.1 billion in 1987. Another sequestration of 6.2 percent in 1987 would reduce defense outlays by an additional $18.1 billion, bringing 1987 outlays $3.6 billion below the 1986 estimated level of $269.5 billion.

The reductions in new budget authority for defense programs are even more striking. The 1986 sequestration reduced new budget authority for the national defense function by $11.4 billion in 1986 and by $11.7 billion in 1987 from CBO baseline levels. A second sequestration of 6.2 percent would reduce new budget authority by another $30 billion in 1987, from $301 billion in CBO's baseline projections to $271 billion. This postsequestration level for 1987 defense budget authority is $49 billion below the Administration's request.

The reductions in outlays for nondefense programs are of similar magnitude as those for defense programs but are relatively smaller in percentage terms because of the exemptions for Social Security benefits and other nondefense programs. The 1986 sequestration has the effect of reducing CBO baseline outlays by $5.9 billion in 1986 and by $7.2 billion in 1987. A second sequestration of 8.4 percent in 1987 would reduce nondefense outlays by another $17.0 billion, bringing total nondefense outlays to within $3 billion of the 1986 level.

APPENDIXES

APPENDIX A

BASELINE CONCEPTS AND ASSUMPTIONS

Baseline budget projections are designed to show what federal government revenues and spending would be in future years if current policies were continued without change. This appendix details the assumptions used in preparing the baseline projections for this volume. The first section describes the revenue baseline and identifies tax provisions that are scheduled to expire during the 1986-1991 projection period. The other two sections explain the baseline projections for budget authority and outlays.

BASELINE REVENUES

Baseline revenues are, with four exceptions, revenues generated under existing tax law. In three of these instances, excise taxes dedicated to trust funds are assumed to be continued beyond their scheduled expiration:

- Taxes for the Hazardous Substance Response Trust Fund (Superfund) are assumed to be extended at the rates in effect when the taxes expired on September 30, 1985.
- Airport and Airway Trust Fund taxes are assumed to be extended at current rates beyond December 31, 1987.
- Highway Trust Fund taxes are assumed to be continued at current rates beyond September 30, 1988.

The Congressional Budget Office has also assumed, at the request of the House and Senate Budget Committees, that the reduction in the federal Civil Service Retirement contribution rate for recently hired workers is extended beyond April 30, 1986.

All other tax provisions that are scheduled to expire between 1986 and 1991 are assumed to do so as specified in law. Among the expiring provisions are the temporary cigarette tax increase enacted in the Tax Equity and Fiscal Responsibility Act of 1982 and subsequently extended through March 14, 1986, and the income tax deduction for charitable contributions by nonitemizers, which is scheduled to expire at the end of 1986. The expiring tax provisions with significant revenue effects, and their expiration dates, are listed in Table A-1.

TABLE A-1. TAX PROVISIONS THAT HAVE SIGNIFICANT REVENUE EFFECTS AND EXPIRE DURING THE 1986-1991 PERIOD

Provision						Date of Expiration
Revenue-Raising Provisions (Expiration of Provision Causes Revenues to Decline)						
Excise Taxes a/						
Cigarettes						March 14, 1986
Telephone						December 31, 1987
	1986	1987	1988	1989	1990	1991
Approximate Revenue Effect (in billions of dollars) b/	-1	-2	-3	-4	-4	-4
Revenue-Losing Provisions (Expiration of Provision Causes Revenues to Increase)						
Energy Tax Expenditures						
Carryover provision for the residential energy tax credit						December 31, 1987
Credit for small-scale hydroelectric facilities for which application has been docketed by the Federal Energy Regulatory Commission before January 1, 1986						December 31, 1988
Decrease in excise tax on newly discovered oil						December 31, 1988
Credit for certain long-term energy projects						December 31, 1990

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a. The CBO baseline assumes extension of Hazardous Substance Response, Airport and Airway, and Highway Trust Fund taxes. Therefore, the revenue loss from their expiration is not included here.

b. Excise tax estimates are net of offsetting income tax effects.

TABLE A-1. (Continued)

Provision	Date of Expiration
Other Tax Expenditures c/	
Deduction for charitable contributions for nonitemizers	December 31, 1986
Exclusion of interest on state and local small-issue industrial development bonds for nonmanufacturing purposes	December 31, 1986
Five-year depreciation of rehabilitation costs on low-income housing	December 31, 1986
Credit for employee stock ownership plans (ESOPs)	December 31, 1987
Tax credit for orphan drug research	December 31, 1987
ACRS for mass transit vehicles	December 31, 1987
Exclusion of interest on qualified mortgage bonds	December 31, 1987
Exclusion of interest on mortgage subsidy bonds and credit for mortgage certificates	December 31, 1987
Six-month holding period for long-term capital gains	December 31, 1987
Exclusion of interest on state and local small-issue industrial development bonds for manufacturing purposes	December 31, 1988

	1986	1987	1988	1989	1990	1991
Approximate Revenue Effect (in billions of dollars)	0	1	6	8	8	9
Net Revenue Effect of All Expiring Provisions (in billions of dollars)	-1	-1	3	4	4	5

SOURCE: Congressional Budget Office.

c. The CBO baseline assumes continuation of the reduction in the federal Civil Service Retirement contribution rate beyond April 30, 1986. Therefore, the revenue gain from its expiration is not shown here.

OVERVIEW OF BASELINE SPENDING CONCEPTS

Baseline spending projections are designed to show what federal government budget authority and outlays would be in future years if current policies were continued without change. The basic methodology for projecting the different types of spending--direct spending programs and discretionary appropriations--is summarized in this section of the appendix. The final section discusses assumptions that differ from the basic methodology.

Federal spending can be divided into two categories. A large part of federal spending is mandated by existing law and is referred to as direct spending. The remainder is subject to annual review through the appropriation process.

Direct Spending

The term direct spending refers to four types of spending that are, in effect, mandatory under existing law: permanent appropriations and trust funds; appropriated entitlements; permanent revolving funds; and offsetting receipts. To affect spending in these programs, the basic substantive law usually must be changed. The baseline spending projections for these programs assume that existing law will continue unchanged, and that future spending will respond to assumed economic and population changes, in essentially the same way as in the past.

The baseline projections for direct spending programs reflect the sequestering of 1986 spending authority as required by the Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177). For programs with cost-of-living adjustments (COLAs), sequestering the 1986 COLA reduces outlays throughout the projection period. For revolving loan funds with an appropriated loan limit, the reduction of the 1986 loan level also reduces the loan levels projected for 1987 to 1991. For other direct spending programs, 1987 spending authority is assumed to return to presequestration levels, and there is no long-run reduction in outlays.

When programs are jointly administered by the federal and state governments (for example, unemployment compensation and Aid to Families with Dependent Children), the projections assume that the states will set eligibility rules and benefit levels in the future in the same manner as they have in the past. In some direct spending programs, the law gives the Administration some freedom of action. For example, the Administration has some discretion in setting hospital reimbursement rates in Medicare, in determining the amount of loan assets sold to the Federal Financing Bank, and in scheduling the auction of leases for lands on the Outer Continental Shelf. In such cases, the baseline generally assumes that the Administration will carry out its most recently announced intentions.

Permanent Appropriations and Trust Funds. In some instances, authority to spend may be provided directly in the legislation that authorizes a program, without the need for subsequent annual appropriations. Examples of such direct spending programs include Medicare, Social Security, and interest on the public debt.

Appropriated Entitlements and Other Mandatory Appropriations. Some benefit programs, called appropriated entitlements, have their budget authority provided in annual appropriations. Examples of appropriated entitlements include Medicaid, Supplemental Security Income, Aid to Families with Dependent Children, and the veterans' compensation and pension programs. The basic legislation for these programs requires the payment of benefits to any person or government meeting the eligibility requirements. The level of spending is mandated in these cases by existing law and cannot be effectively controlled through the appropriation process.

In addition, certain appropriated accounts are treated as mandatory for projections purposes, even though the House and the Senate Budget Committees do not both consider them entitlements. The list of mandatory items is that used in the so-called bipartisan baseline, which served as the basis for developing the 1983 budget resolution. The projections for the Food Stamp program, for example, are computed as if the program were mandatory, since the Congress has always appropriated enough money to cover all benefit payments to eligible recipients. Other programs treated as mandatory include child nutrition, unemployment trust fund outlays for training and employment services and for administrative expenses, payments to air carriers, Maritime Administration operating differential subsidies, rehabilitation services, government payments for annuitants' health benefits, payments in lieu of taxes, and certain miscellaneous trust funds. Some federal payments to Civil Service Retirement and other trust funds, while considered mandatory, are exactly offset by corresponding intragovernmental receipts and have no effect on total outlays.

Revolving Loan Funds. The federal government administers many lending programs through revolving funds. Such funds disburse loans and accept repayments of principal and interest. CBO calculates a baseline for such programs by first developing a lending level for each year of the projections. For fiscal years in which the Congress has set a lending limit, CBO uses that limit (reduced in accordance with the Balanced Budget Act) as a base for projections. If no limit has been set, CBO estimates the base-year lending level to be equal to average program experience over the past few years, adjusted for inflation. For subsequent years in which the Congress has yet to set a ceiling, CBO projects a baseline lending level by inflating the base-year level. Net budget authority and outlays are estimated using these lending levels, projected loan repayments, and established government accounting practices for revolving funds.

Offsetting Receipts. Certain receipts from the public resulting from the federal government's business-type activities and certain intragovernmental receipts are automatically credited to special receipt accounts and are treated as negative spending. They are deducted from other budget authority and outlays in computing budget totals rather than being counted as revenues. Examples of such receipts include those from premiums for Supplementary Medical Insurance, from the sale of timber in national forests, and from rents and royalties from Outer Continental Shelf lands. In the baseline projections, the amount of these receipts is estimated on the assumption that current government policies regarding the extent of timber sales, the scope and timing of offshore leasing activities, and so forth, will be continued, and that actual receipts will respond to underlying economic and demographic conditions, such as the prices of lumber and oil and the number of Medicare enrollees.

Annual Appropriations

The rest of federal spending is controlled by and requires annual action through the appropriation process. The fiscal year 1986 spending level assumed for these programs is that enacted by the Congress through December 1985 and reduced according to the provisions of the Balanced Budget Act. Because the sequestration of budgetary resources permanently cancels budget authority, the 1986 appropriation is the postsequestration amount. The 1987-1991 projections for the appropriated accounts represent a continuation of the program levels embodied in the 1986 appropriation, which is taken as the most current indication of Congressional policy.

For most appropriated accounts, future budget authority is assumed to stay constant in real terms--that is, to keep pace with a measure of inflation appropriate to the particular budget account. In a few instances, the baseline budget authority is the estimated amount required to achieve specified program objectives--for example, a fill rate for the Strategic Petroleum Reserve. Where the 1986 appropriation reflects the availability of unobligated balances, the 1986 projection base is assumed to be the 1986 program level--that is, 1986 budget authority plus activity financed by available balances. Where 1986 funds have been deferred until 1987, the 1987 baseline budget authority is reduced to reflect the availability of the deferred funds.

Although statutory authority for most discretionary programs will expire during the five-year projection period, authorizations are assumed to be routinely renewed except for programs that are clearly of a one-time nature, such as temporary study commissions. The projected growth in budget authority is limited by any authorization limit that may have been set by the Congress; if the limit ceases to apply in some future year, budget authority is assumed to rise with inflation thereafter. If the base-year appropriation exceeds the authorization, the projections also ignore the authorization limit, which is considered to have been rendered moot by the subsequent appropriation. It is further assumed that budget authority will result in outlays according to the observed historical pattern for the particular account.

SPECIAL ASSUMPTIONS FOR SPENDING

Most spending is projected using the baseline concepts and approaches described in the previous section of this appendix. This section provides further information for those budget accounts requiring special assumptions or methodology. Accounts projected using the standard techniques are not discussed.

National Defense (Function 050)

The defense baseline assumes that budget authority keeps pace with inflation--the same approach used generally for nondefense discretionary programs. Outlays in each year are CBO estimates of spending resulting from the assumed budget authority. The outlay estimates in 1986 for the military personnel accounts reflect the expected transfer of prior-year appropriations to fund pay raise and retirement costs. The budget authority and outlay projections for 1987-1991 assume that new funding is provided to maintain the 1986 military manpower levels. Also, the projection assumes no additional funding for defense-related loans of the Federal Financing Bank not resulting from current programs.

The two major components of the defense budget are federal employee pay and benefits (about one-third of 1986 budget authority) and purchases of goods and services (the remaining two-thirds). The inflation factor for federal employee pay and benefits is the assumed rate of pay increase; in the baseline, CBO assumes that federal employee wages are increased at the same rate as those in the private economy. The inflation factors for the other components of the defense budget are derived by projecting price changes in specific defense industries consistent with the baseline economic assumptions.

Baseline inflation rates for these two major components of defense spending and a composite rate for defense spending as a whole are shown in Table A-2. Because there is often a long lag between the obligation of

TABLE A-2. DEFENSE INFLATION RATES UNDER CBO BASELINE ASSUMPTIONS (By fiscal year, in percent)

Component	1986	1987	1988	1989	1990	1991
Budget Authority Inflation Rate						
Pay and Benefits	2.0	3.2	5.7	5.9	5.9	6.1
Purchases	3.1	3.6	4.0	4.1	4.1	4.1
Composite	2.8	3.4	4.6	4.7	4.7	4.8
Outlay Inflation Rate						
Pay and Benefits	2.0	3.2	5.7	5.9	5.9	6.1
Purchases	3.1	3.1	3.8	4.1	4.1	4.1
Composite	2.7	3.1	4.5	4.7	4.7	4.8

Source: Congressional Budget Office.

defense funds and the actual production of the defense goods, different inflation rates are computed for budget authority and outlays. For those procurement accounts whose budget authority will result in outlays over many years, the inflation rate for budget authority reflects projected changes in prices over the period during which the budget authority will be spent. The outlay inflation rate, on the other hand, reflects only price changes in the current year.

The defense baseline assumes that the number of people in active and reserve military service remains constant. For 1986 the Congress provided $67.7 billion in budget authority and $4.8 billion in transfer authority to fund the manpower program. The transfers would come from unobligated balances in other accounts to the extent necessary to fund the costs of the military pay raise that became effective October 1, 1985, and to fund the accrued costs of military retirement. The Defense Department has been paying these costs as if it will invoke the transfer authority, and CBO estimates 1986 outlays for the military personnel accounts on this assumption. The baseline projections assume that sufficient new budget authority will be provided in 1987 and thereafter to continue current manpower levels.

While CBO's defense baseline assumes no real growth in defense program levels, the Administration's current services projections assume the figures for defense budget authority in the 1986 Congressional budget resolution. This conceptual issue is discussed in Chapter II of this volume. CBO and the Administration also differ in their estimates of the amount of outlays resulting from a given level of defense budget authority. These technical estimating differences will be discussed in detail in CBO's forthcoming report, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1987.*

International Affairs (Function 150)

Contributions to Multilateral Development Banks. The United States and other donor countries periodically enter into agreements providing additional resources for the multilateral development banks. The replenishment agreement, as it is called, can extend over a number of years, with annual appropriations as partial payments. Once signed, the agreement is treated as binding. If one year's appropriation is less than the scheduled contribution, the difference is included in subsequent budget requests until the full amount is provided. Arrearages, or the difference between the requested amount and the postsequestration amount provided in the continuing resolution (Public Law 99-190), are assumed to be provided in fiscal year 1987. The projections assume that future replenishments of paid-in capital and contributions to the concessional lending windows of the regional banks will be negotiated with the same terms and conditions that are in the most recent replenishments, but with no real growth in funding levels.

Public Law 480 Food Assistance Program. The Public Law 480 food assistance program is projected using the postsequestration obligation levels contained in the continuing resolution as the base. Budget authority equals the new appropriations required to finance the program, and outlays equal gross disbursements less receipts credited to the account.

International Monetary Fund. The United States has been a member of the International Monetary Fund (IMF) since the Bretton Woods Agreement in 1944 and has participated in every increase in IMF resources since then. Quota subscriptions have been raised roughly every five years, with the most recent increase in fiscal year 1984. The baseline assumes another increase in fiscal year 1989 equal to an amount sufficient to maintain the real level of the current U.S. quota subscription. No increase in the General Arrangement to Borrow is projected. Dollar transfers with the IMF are treated by the Treasury as an exchange of international reserve assets and are not counted as net budget outlays, although they do affect the Treasury's cash position and borrowing requirements.

Guarantee Reserve Fund. In fiscal year 1981, the Congress ceased appropriating an amount equal to a portion of guaranteed foreign military credits as a reserve for problem loans. Funds appropriated as reserves in earlier years were consolidated in a revolving fund to make payments on rescheduled loans and defaults. By 1984 the fund had been reduced to a point requiring replenishment. The Administration requested appropriations sufficient to maintain a reserve of 2 percent of the contingent liability, but the Congress provided less than the requested amount. The projections assume appropriations will be required to meet the estimated outlays from the fund after fiscal year 1987.

Special Defense Acquisition Fund. Net outlays are estimated by projecting the limits on new obligations contained in appropriation acts.

Export-Import Bank. Direct loan obligations are estimated to equal the direct loan limits throughout the projections period. Budget authority measures potential borrowing requirements resulting from bank activity. It equals direct loan obligations less direct loan cancellations, loan repayments, and bank net income, plus redemption of debt and any change in the balance of unobligated borrowing authority available to the bank. Outlays equal gross disbursements less collections.

General Science, Space, and Technology (Function 250)

Spending in this function is projected using the general baseline concepts previously described.

Energy (Function 270)

Tennessee Valley Authority and Bonneville Power Administration. These two accounts are funded by permanent indefinite borrowing authority subject to a cap. The baseline projection of budget authority for these accounts is an estimate of the borrowing authority required to finance their capital investments. The outlay projections are CBO's best estimate of capital spending net of receipts. All operating expenses are assumed to be covered by revenues from ratepayers.

Uranium Enrichment. The baseline projection for this account reflects the difference between the program's spending and receipts. CBO's projection of budget authority assumes that the Congress will continue to appropriate an amount equal to the program's estimated receipts in each year. Receipts from civilian customers are projected on the basis of current prices and anticipated sales. The projection of intragovernmental receipts from the defense atomic energy program is based on the amount appropriated in 1986, adjusted for inflation in future years.

Sale of Minerals and Mineral Products. This is an offsetting receipt account, to which are credited the receipts from the sale of oil and other petroleum products from the Naval Petroleum Reserves. The estimate of receipts is based on the estimated price of oil, the rate of production from the reserves, and an estimate of receipts generated from the sale of other petroleum products. For 1986, the estimate includes the effect of transferring 30 percent of net receipts to the national defense budget function, as required by the Defense Authorization Act of 1985.

Nuclear Waste Fee. This account represents CBO's estimate of receipts collected from the fee imposed by the Nuclear Waste Policy Act of 1982. That law levies a fee of 0.1 cent per kilowatt hour on electricity generated by nuclear power plants. CBO bases its estimate on the output of completed units and on plants scheduled to being operation in each year. The estimate assumes that the fee remains constant through 1991.

Nuclear Waste Program. This account reflects spending by the Department of Energy to develop repositories for the disposal of high-level radioactive waste. CBO's projection of budget authority includes the amount that the department estimates will be needed each year to develop repositories in compliance with the procedural and scheduling requirements in the Nuclear Waste Policy Act of 1982. Funding for general support activities is projected to continue at the 1986 level, adjusted for inflation in future years.

Clean Coal Technology Reserve. The Congress established a $400 million Clean Coal Technology program in the 1986 continuing resolution. The funds for this program were made available by transfer from the Energy Security Reserve: $100 million in 1986, $150 million in 1987, and $150 million in 1988. The baseline projection assumes that the Congress will continue to fund the Clean Coal program at the 1988 level, adjusted for inflation, in fiscal years 1989-1991. The baseline projection also assumes that the relation between outlays and budget authority will be similar to that for comparable federal research programs.

Strategic Petroleum Reserve. The Congress has created two accounts for the Strategic Petroleum Reserve: one that funds operation and construction of the reserve and one that funds oil acquisition. The baseline estimate for operation and construction assumes that the planned reserve of 750 million barrels is completed and maintained. The baseline projection for oil acquisition assumes purchasing and filling the reserve at a rate of 29,300 barrels per day throughout the 1986-1991 period. The fill rate for 1986 was determined by the Supplemental Appropriations Act of 1985 (Public Law 99-88), which specified that the reserve be filled to a level of 500 million barrels by the end of 1986. Assuming continued fill at the 1986 rate, the reserve will contain approximately 553 million barrels by the end of 1991. Projections for budget authority and outlays are derived using CBO's oil price assumptions.

Natural Resources and Environment (Function 300)

Fire Fighting. Several accounts in this function include money for fighting forest and range fires on federal lands. The responsible agencies generally cover their current fire-fighting costs by borrowing from other accounts and repaying the borrowed amount through a supplemental appropriation the following year. The 1986 base levels for these accounts have been increased to reflect the actual cost of fire fighting in 1985. The projections for 1987 through 1991 are based on average fire-fighting costs in the past five years, adjusted for inflation.

Construction Grants. In the 1986 continuing resolution (Public Law 99-190), the Congress appropriated $2.4 billion for the Environmental Protection Agency's construction grants program. Of that amount, only $600 million is immediately available for obligation, with the balance requiring release in a subsequent appropriation act. The CBO baseline assumes a base-year program level of $2.4 billion, reduced as required by the Balanced Budget Act. Outlay estimates assume that the $1.8 billion in 1986 appropriations not immediately available for obligation will not be obligated this year.

Agriculture (Function 350)

Commodity Credit Corporation. The baseline outlay estimates of activities of the Commodity Credit Corporation (CCC) are estimates of likely expenditures assuming the terms and conditions of the Food Security Act of 1985, expected Administration actions in implementing the legislation, and CBO projections of commodity prices and production. Target prices, loan rates, and terms of acreage reduction programs for the 1986 crops of wheat, feed grains, cotton, and rice have already been announced. Advance deficiency payments, which are required for the 1986 crops and have been set at 40 percent of estimated total deficiency payments, are also assumed to be made for the 1987 through 1991 crops. The milk production termination program, scheduled to begin on April 1, 1986, is assumed to reduce CCC net removals of surplus milk products to between 3.0 billion and 3.5 billion pounds milk-equivalent per year by the end of fiscal year 1987.

Commerce and Housing Credit (Function 370)

Periodic Census and Programs. The baseline is irregular because of the cyclical nature of the activities conducted by the Bureau of the Census. An adjustment is made to exclude one-time items (generally major capital expenditures) and to include future censuses required by law. The various major components are then adjusted for inflation after the base year.

Patent and Trademark Office. The baseline projection of budget authority is the difference between receipts and operating expenses for the Patent and Trademark Office, as estimated by CBO. The estimate of receipts is based on projected collections from license fees for jukeboxes and cable television. The operating expenses are projected from the 1986 base and assume a constant level of activity.

Transportation (Function 400)

Federal-Aid Highways. The Surface Transportation Assistance Act of 1982 (Public Law 97-424) specifies budget authority for the Interstate highway program at $4 billion each year through fiscal year 1989, and for the emergency relief program at $100 million through the projection period. Since budget authority for non-Interstate highway programs is provided by the law only through 1986, the baseline adjusts that level for inflation in future years. In 1986, appropriation action limited obligations to $12.75 billion; this level was subsequently reduced to $12.2 billion by the Balanced Budget Act. The baseline assumes that this ceiling is adjusted for inflation after 1986.

Washington Metropolitan Area Transit Authority (WMATA) Interest Payments. The federal government's share of interest payments due on WMATA's outstanding debt issue is projected to remain constant at $51.7 million through fiscal year 1990, as authorized by Public Law 96-184.

Interstate Transfer Grants. Until the end of fiscal year 1983, state and local governments could request withdrawal of a segment of the Interstate highway system in their area if they determined that it was not essential. If federal officials concurred, the state was then eligible to use the funds that would have been spent on the withdrawn segment for a transit project. The baseline includes the total outstanding cost of approved substitute transit projects--approximately $870 million at the beginning of fiscal year 1986.

Washington Metro. Public Law 96-184 authorized a total of $1.7 billion in federal funds for construction of the Washington metrorail system. A total of $957 million has been appropriated to date (including $217 million in fiscal year 1986), leaving $743 million to be appropriated.

Mass Transportation Capital Fund. The Surface Transportation Assistance Act of 1982 set aside one cent of the gasoline and diesel fuel excise tax for mass transportation purposes and provided budget authority for discretionary grants through 1986. The baseline adjusts that level for inflation in future years. The obligation ceiling of $1.0 billion for 1986 is also adjusted for inflation in the future.

Highway Safety Grants. Budget authority for state and community highway safety grants is established by law through fiscal year 1986 and is adjusted for inflation in the future. The obligation ceiling for 1986 is higher than the budget authority, and the baseline also adjusts that level for inflation. As a result, the obligation ceiling is projected to remain higher than the budget authority throughout the projection period.

Conrail Receipts. The federal government currently owns $851 million of Conrail debentures and $2.3 billion of preferred stock. Conrail is required to pay interest, dividends, and principal to the government when its net income reaches a certain level. CBO estimates that, under current law, payments to the federal government will begin in 1988.

Payments to Air Carriers. The Airline Deregulation Act of 1978 (Public Law 95-504) established a program to guarantee air transportation to certain communities by subsidizing air carriers. The Department of Transportation determines the required level of service and compensates the airlines accordingly. The act authorizes this program through October 1988.

Grants-in-Aid for Airports. Budget authority for fiscal years 1986 and 1987 is established for this program in the Airport and Airway Improvement Act of 1982 (Public Law 97-248) and the Surface Transportation Assistance Act of 1982. For fiscal years 1988 through 1991, 1987 budget authority is adjusted for inflation. Outlay estimates are based on obligation ceilings; the 1986 obligation ceiling of $885 million is adjusted for inflation in future years.

Operating Differential Subsidy. The Maritime Administration's operating differential subsidy program is designed to offset the higher costs of operating U.S.-flag vessels in foreign trade. The projection of budget authority represents the estimate of the federal government's liability under the contracts in force for the projection period, which depends on an assumed ship mix, trade routes, products carried, and number of ship-years.

Community and Regional Development (Function 450)

Disaster Assistance. Three major programs in this function help mitigate the effects of disasters on individuals, businesses, and local governments. Through these programs, the federal government provides flood insurance, loans to help restore damaged property, and grants to assist victims. Because of the unpredictable demand for these programs, baseline projections are based on weighted historical averages, adjusted for inflation and changes in regulations. Should additional funding be required, the Congress has repeatedly shown its willingness to provide needed emergency funds in supplemental appropriation bills.

In fiscal year 1986, disaster loan obligations of the Small Business Administration are capped by law at $600 million. CBO estimates that demand for these loans, primarily from farmers, exceeds this obligation ceiling. Consequently, loan volume increases sharply in fiscal year 1987 with the expiration of the ceiling. Loans increase again in fiscal year 1988, when new restrictions on eligibility for disaster loans from the Farmer's Home Administration take effect. The 1988 loan level is adjusted for inflation in fiscal years 1989 through 1991.

Education, Training, Employment, and Social Services (Function 500)

Corporation for Public Broadcasting. The Corporation for Public Broadcasting is advance funded; the fiscal year 1986 appropriations act provides funds for 1988. The baseline in 1986-1988 reflects the amount appropriated for those years. After 1988, the baseline is derived by inflating the 1988 appropriation by estimated price changes.

Health (Function 550)

No unusual assumptions apply to this function.

Medicare (Function 570)

Hospital Insurance. The Social Security Amendments of 1983 (Public Law 98-21) instituted a prospective reimbursement system for inpatient hospital services. Under this system, patients are classified into 468 diagnosis-related groups (DRGs). After a three-year phase-in period, hospitals will be paid a fixed amount per DRG. The Secretary of Health and Human Services has, by regulation, frozen the 1986 reimbursement rates at their 1985 amounts. The President's 1987 budget reflects a 2 percent increase in the DRG rates for 1987. (The final decision on the 1987 increase will be made later this year, after the Secretary has considered the report of the Prospective Payment Assessment Commission.) For 1988 through 1991 the budget assumes that the DRG rates will be increased at the rate of increase of a market basket of goods and services purchased by hospitals. The CBO baseline assumes that the Secretary will implement the policies set forth in the budget.

Income Security (Function 600)

Pension Benefit Guaranty Corporation. The Pension Benefit Guaranty Corporation (PBGC) fund receives premium and interest income and pays benefits and administrative expenses. The net outlays of the fund grow through 1988. After 1988, net outlays are assumed to be negligible because it is assumed that the PBGC's assets are drawn down in an amount sufficient to make income equal expenditure. Alternatively, the PBGC could borrow up to $100 million from the Treasury or reduce benefit payments below guaranteed levels.

Subsidized Housing Programs. By the end of the projection period, large numbers of existing Section 8 rental assistance contracts will have expired. These are agreements that were made in 1976 and 1977 and were among the first Section 8 contracts written. The baseline contains an estimate of the funding that will be required to keep these assisted housing units under payment for another 15 years. These assumed renewals add about $20 billion to baseline budget authority in fiscal year 1991.

Nutrition Assistance for Puerto Rico. The Congress appropriated $820 million for Nutrition Assistance for Puerto Rico in 1986, $5 million short of the level authorized for the program under the Food Security Act of 1985. The baseline increases the 1986 appropriated amount to keep pace with higher food prices. Baseline levels remain slightly under the amounts authorized for 1987 and 1988 and equal the authorization levels in 1989 and 1990. If the authorization levels were interpreted as mandatory floors as well as ceilings, baseline spending for Nutrition Assistance for Puerto Rico would be $12 million higher over the 1986-1988 period.

Refugee and Entrant Assistance. The projections for cash and medical assistance to refugees are based on the projected State Department ceiling of the number of refugees allowed to enter the United States. These costs are projected to decrease because of a decline in the number of refugees entering the country. The other programs of refugee assistance are held constant in real terms.

Social Security (Function 650)

The Balanced Budget and Emergency Deficit Control Act of 1985 removed the receipts and disbursements of the Old-Age and Survivors Insurance and Disability Insurance trust funds from the budget. Payments to the trust funds for such items as military service wage credits, coverage of certain uninsured beneficiaries, Self-Employment Contribution Act tax credits, and income tax liabilities derived from the taxation of Social Security benefits remain on-budget.

Veterans' Benefits and Services (Function 700)

Veterans' Compensation. The veterans' and survivors' compensation program is not indexed for inflation by law, but benefit levels historically have been adjusted through annual legislation to cover increases in the cost of living. The CBO baseline assumes that future increases in compensation will be enacted at the same percentage rate as for Social Security and veterans' pensions and will be effective on December 1 of each year, as they were in 1984 and 1985.

Veterans' Readjustment Benefits. These programs are not indexed by law and receive legislated increases in benefit levels only sporadically. Because the timing and amount of future legislated increases cannot be predicted with any degree of confidence, the baseline for these accounts assumes no change in the current nominal benefit rates. The baseline assumes that the Peacetime Educational Benefits program will expire as scheduled on June 30, 1988, at which time the operation of the Post-Vietnam Era Educational Assistance program will resume.

Loan Guaranty Revolving Fund. This entitlement program guarantees loans made by private lenders to veterans who meet the financial qualifications. The baseline outlays for the fund reflect the net default costs resulting from foreclosures of guaranteed loans. Baseline budget authority projections represent the amounts of any appropriations estimated to be required to ensure the solvency of the fund. Under current law, an origination fee of 1 percent of the loan principal is required on new loans guaranteed for non-service-disabled veterans. Authority for this fee is scheduled to expire after September 30, 1987. The CBO baseline assumes that the authority to impose this fee will be extended throughout the projection period.

Administration of Justice (Function 750)

The 1987 baseline budget authority for several accounts in this function exceed the 1986 appropriation by more than the rate of inflation because of additional spending requirements imposed by recent legislation, including the Comprehensive Crime Control Act, the Bankruptcy Amendments and Federal Judgeship Act, and the Pretrial Services Act.

General Government (Function 800)

Official Mail Costs. Congressional postage fees are paid out of this account. CBO's projection of mail costs is based on estimated usage and reflects historical patterns.

Federal Buildings Fund. This revolving fund finances the real property operations of the government. Space and services are provided to agencies by the General Services Administration (GSA), which is reimbursed by the agencies. Obligations and disbursements from the fund are subject to limitations on the availability of revenue imposed through the appropriation process. CBO's estimate of outlays is based on the sum of estimated outlays for property management and estimated receipts from the collection of standard-level user charges from agencies. By law, the user charges paid by agencies to GSA are supposed to approximate commercial charges for comparable space and services. Administrative action by the Office of Management and Budget limited user charges in fiscal year 1986 to the rates in effect for 1985. The baseline projections assume that user charges will be set at 85 percent of commercial equivalent rates in 1987 and will increase to 100 percent of commercial equivalent rates by 1989.

Compact of Free Association. The Compact of Free Association provides that the United States will make payments to the Federated States of Micronesia and the Republic of the Marshall Islands over the next 15 years. While the compact was signed into law in January 1986, the President has discretion in determining when the payments will begin. The baseline assumes that the first-year payments required by the compact will be made in a 1986 supplemental appropriation.

General Purpose Fiscal Assistance (Function 850)

Miscellaneous Permanent Appropriations for the Forest Service and Minerals Management Service. Certain percentages of the federal government's receipts from leasing rights and logging on federal land are paid to local units of government. CBO projections for these permanent appropriations are therefore based on estimated timber and mineral receipts, which are recorded in budget function 300.

General Revenue Sharing. Budget authority for payments to local governments under the general revenue sharing program has been authorized at $4.6 billion annually through 1986, although the 1986 appropriation was lower. The baseline assumes that the program will be continued at the previously authorized level in 1987 through 1991.

Net Interest (Function 900)

The net interest function comprises interest on the public debt, interest received by certain trust funds, and other interest. The methodology for projecting net interest costs is described in a CBO special study, *Federal Debt and Interest Costs* (September 1984).

Allowances (Function 920)

The baseline projections for this function contain budget authority and outlays resulting from assumed pay rate increases for all federal employees of civilian agencies. The projections assume pay rate increases equal to the annual rate of growth in private-sector pay--3.3 percent in October 1986, 5.8 percent in October 1987, 5.9 percent in October 1988, 5.9 percent in October 1989, and 6.1 percent in 1990. CBO assumes that additional appropriations are provided to cover these increases and that federal agencies will not be required to absorb any of the cost.

The baseline projections also assume expiration of Section 301(b) of the Omnibus Budget Reconciliation Act of 1982, which changed the determination of hourly rates for certain white-collar employees for fiscal years 1984 and 1985. Since October 1985, an employee's hourly rate of pay has been derived by dividing the annual rate of pay by 2,080 hours.

Uniformed military employees of the Coast Guard and of other civilian agencies received a pay increase of 3.0 percent in October 1985, and some blue-collar employees received a 3.5 percent increase during the first quarter of fiscal year 1986 (owing to the three-month delay of the 1985 increase). As a result, civilian agencies will incur costs of about $30 million for the adjustment for uniformed employees and about $3 million for the carry-over adjustment for blue-collar employees. The baseline does not assume enactment of any supplemental appropriation to cover these increases.

Undistributed Offsetting Receipts (Function 950)

Employer's Share, Employee Retirement. The government's contribution to federal employee retirement plans is assumed to grow in proportion to assumed pay rate increases and scheduled increases in contribution rates.

Outer Continental Shelf Receipts. Outer Continental Shelf (OCS) receipts consist of cash bonus bids from lease sales, annual rental payments, royalties on oil and gas production, and payments to the federal government resulting from the release of disputed OCS receipts from escrow accounts. Bonus receipts for fiscal years 1986 and 1987 are estimated on a sale-by-sale basis, reflecting bonus bids on previous offerings in the area in which a sale will occur, the Minerals Management Service (MMS) estimate of oil and gas reserves in the sale area, and CBO oil and gas price assumptions. Bonus receipts for subsequent years are assumed to remain at the 1987 level. Escrow releases are dependent on resolution of various court cases and negotiations between nonlitigating states and the Secretary of the Interior; timing of those releases is estimated based on information from the Department of the Interior and from the states concerned. Royalty receipt estimates are based on MMS projections of oil production and CBO projections of gas production and oil and gas prices.

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APPENDIX B

BASELINE SPENDING AND CREDIT PROJECTIONS BY BUDGET FUNCTION

Five broad categories of outlays--defense, entitlements and other mandatory spending, nondefense discretionary spending, net interest, and offsetting receipts--used in the body of this report are designed to reflect the way in which the Congress has approached spending decisions in recent budget resolutions. In this appendix, federal spending and credit projections are classified according to 21 budget functions.

The Congressional Budget Act of 1974 requires the Congress to include estimates of budget authority and outlays for each major budget function in its annual budget resolutions. The functional classification is a means of presenting spending estimates in terms of the broad national needs that federal programs are intended to address. Within a function, the programmatic objectives may be achieved in a variety of ways, including spending from Congressional appropriations, loans to private borrowers, and spending from earmarked trust funds.

National needs are grouped into 18 broad budget functions ranging from national defense, international affairs, energy, and agriculture programs to education, health, income security, and general purpose fiscal assistance to state and local governments. The three remaining functions--net interest, allowances, and undistributed offsetting receipts--do not address national needs but are included to make the budget complete.

Some outlays are excluded from the on-budget totals by law. The Balanced Budget and Emergency Deficit Control Act of 1985 provides that the outlays (and revenues) of the Social Security trust funds are to be excluded from the on-budget aggregates. Outlays for the Social Security retirement, survivors, and disability programs are classified in budget function 650. Most spending in this function--representing the outlays of the Old-Age and Survivors Insurance and Disability Insurance trust funds for benefit payments, administrative expenses, and other miscellaneous costs--is treated as off-budget. Off-budget outlays in net interest (function 900) reflect the interest earned by the Social Security trust funds on their investments in Treasury securities, while the off-budget portion of function 950 (undistributed offsetting receipts) reflects the payroll tax paid by federal government agencies on behalf of workers covered under the program.

Since 1980, Congressional budget resolutions have also included a separate credit budget. The spending budget, which generally operates on a cash flow basis, cannot accurately reflect the full impact of federal budgetary policies on the allocation of credit in the U.S. economy. In the spending budget, loans are recorded on a net basis--that is, new loans less repayments. Loan guarantees do not appear at all except in the case of a default. The credit budget remedies some of these shortfalls by presenting the gross amounts of new loans and loan guarantees. Most credit budget activity is concentrated in a few budget functions: international affairs, agriculture, commerce and housing credit, education, and veterans' programs.

The CBO baseline projections for budget authority, outlays, and credit are presented by budget function in Tables B-1, B-2, and B-3, respectively. The projection period is fiscal years 1987 through 1991.

TABLE B-1. CBO BASELINE BUDGET AUTHORITY PROJECTIONS BY FUNCTION (By fiscal year, in billions of dollars)

Budget Function	1986 Base	Projections				
		1987	1988	1989	1990	1991
050 National Defense	286.8	300.9	314.7	329.5	345.0	361.5
150 International Affairs	18.9	20.2	20.8	24.4	20.9	21.7
250 General Science, Space, and Technology	8.8	9.3	9.7	10.2	10.7	11.2
270 Energy	-1.1	5.2	5.7	6.0	6.3	6.7
300 Natural Resources and Environment	12.6	12.9	13.3	13.7	14.2	14.6
350 Agriculture	31.4	23.8	26.3	25.3	20.4	16.3
370 Commerce and Housing Credit	10.0	10.9	11.3	9.4	11.7	10.5
400 Transportation	28.1	29.1	29.8	30.6	31.3	32.5
450 Community and Regional Development	7.0	6.9	8.4	8.5	9.0	9.0
500 Education, Training, Employment, and Social Services	30.3	31.9	33.3	34.7	36.1	37.7
550 Health	36.4	38.4	41.0	43.6	46.3	49.2
570 Medicare	86.7	83.6	92.2	102.1	112.1	122.3
600 Income Security	156.2	163.9	171.5	176.4	184.7	217.7
650 Social Security						
On-budget	4.8	5.5	6.2	6.9	6.9	6.1
Off-budget	194.7	221.1	250.6	274.0	303.0	332.3
Subtotal	199.5	226.6	256.7	280.9	310.0	338.4
700 Veterans' Benefits and Services	27.3	27.6	28.2	28.5	28.9	29.5
750 Administration of Justice	6.8	6.9	7.1	7.2	7.3	7.5
800 General Government	5.9	5.7	5.9	5.8	6.2	6.3
850 General Purpose Fiscal Assistance	5.4	6.6	6.6	6.7	6.8	6.9
900 Net Interest						
On-budget	142.8	149.5	160.5	166.2	170.5	175.1
Off-budget	-4.2	-4.6	-6.2	-8.6	-11.4	-14.8
Subtotal	138.6	145.0	154.4	157.6	159.1	160.3
920 Allowances	0.0	1.0	3.0	5.1	7.4	9.9
950 Undistributed Offsetting Receipts						
On-budget	-31.3	-32.7	-36.0	-36.8	-37.6	-39.7
Off-budget	-2.9	-3.2	-3.8	-4.3	-5.0	-5.6
Subtotal	-34.2	-35.9	-39.8	-41.1	-42.6	-45.4
ON-BUDGET	873.8	907.2	959.6	1,004.0	1,045.0	1,112.3
OFF-BUDGET	187.6	213.3	240.6	261.1	286.6	311.9
TOTAL	1,061.4	1,120.5	1,200.3	1,265.2	1,331.6	1,424.2

TABLE B-2. CBO BASELINE OUTLAY PROJECTIONS BY FUNCTION
(By fiscal year, in billions of dollars)

Budget Function	1986 Base	Projections				
		1987	1988	1989	1990	1991
050 National Defense	269.5	284.0	296.4	310.9	326.9	343.9
150 International Affairs	17.1	15.3	15.8	15.8	16.0	16.6
250 General Science, Space, and Technology	8.9	9.1	9.4	9.8	10.3	10.8
270 Energy	4.2	5.2	5.3	5.3	5.4	5.6
300 Natural Resources and Environment	12.8	13.1	14.1	13.9	14.0	14.3
350 Agriculture	30.4	23.2	24.7	21.1	15.8	12.9
370 Commerce and Housing Credit	4.2	4.0	5.3	3.6	3.6	2.3
400 Transportation	27.5	27.4	27.4	28.1	28.8	29.6
450 Community and Regional Development	7.9	7.7	7.8	8.0	8.0	8.3
500 Education, Training, Employment, and Social Services	30.8	30.9	32.2	33.4	34.8	36.3
550 Health	35.6	38.5	40.9	43.2	46.0	48.9
570 Medicare	68.4	75.3	84.6	94.8	106.2	119.0
600 Income Security	119.6	124.1	130.6	135.2	140.5	148.2
650 Social Security						
On-budget	8.1	5.5	6.2	6.9	6.9	6.1
Off-budget	191.5	206.0	220.1	234.8	251.3	269.8
Subtotal	199.5	211.6	226.3	241.7	258.2	275.9
700 Veterans' Benefits and Services	26.7	27.0	27.8	28.1	28.5	29.2
750 Administration of Justice	6.8	7.0	7.1	7.3	7.4	7.5
800 General Government	6.0	5.7	5.9	5.9	6.2	6.3
850 General Purpose Fiscal Assistance	5.8	6.2	6.6	6.7	6.8	6.9
900 Net Interest						
On-budget	142.8	149.5	160.5	166.2	170.5	175.1
Off-budget	-4.2	-4.6	-6.2	-8.6	-11.4	-14.8
Subtotal	138.6	145.0	154.4	157.6	159.1	160.3
920 Allowances	0.0	1.1	3.2	5.5	8.0	10.7
950 Undistributed Offsetting Receipts						
On-budget	-31.3	-32.7	-36.0	-36.8	-37.6	-39.7
Off-budget	-2.9	-3.2	-3.8	-4.3	-5.0	-5.6
Subtotal	-34.2	-35.9	-39.8	-41.1	-42.6	-45.4
ON-BUDGET	801.7	827.0	875.7	912.9	952.8	998.5
OFF-BUDGET	184.4	198.3	210.2	221.9	234.9	249.4
TOTAL	986.1	1,025.3	1,085.9	1,134.9	1,187.7	1,247.9

TABLE B-3. CBO BASELINE CREDIT PROJECTIONS BY BUDGET FUNCTION (By fiscal year, in billions of dollars)

Budget Function		1985 Actual	1986 Base	Projections 1987	1988	1989	1990	1991
050 Defense	DL	1.5	0.5	0.0	0.0	0.0	0.0	0.0
150 International Affairs	DL	8.0	8.7	8.7	9.0	9.3	9.6	10.0
	PG	8.2	11.8	12.2	12.8	13.3	13.8	14.4
270 Energy	DL	4.1	2.1	2.1	2.2	2.2	2.3	2.4
	PG	a/	0.0	0.0	0.0	0.0	0.0	0.0
300 Natural Resources and Environment	DL	a/	a/	a/	a/	a/	a/	a/
	PG	0.0	0.0	0.0	0.0	0.0	0.0	0.0
350 Agriculture	DL	15.2	19.9	14.3	12.0	11.3	10.0	9.4
	PG	3.8	7.1	8.0	8.5	8.6	8.8	8.9
370 Commerce and Housing Credit	DL	5.7	5.0	5.1	5.2	5.6	5.6	5.7
	PG	51.2	57.7	40.5	42.2	43.8	45.6	47.4
400 Transportation	DL	a/	0.7	0.5	a/	a/	a/	a/
	PG	a/	a/	a/	a/	a/	a/	a/
450 Community and Regional Development	DL	1.3	1.4	1.7	2.3	2.2	2.3	2.4
	PG	0.1	a/	a/	a/	a/	a/	a/
500 Education, Training, Employment, and Social Services	DL	1.3	1.5	1.5	1.5	1.5	1.4	1.4
	PG	8.9	10.0	10.5	10.7	10.9	11.1	11.2
550 Health	DL	a/	a/	a/	a/	a/	a/	a/
	PG	a/	a/	a/	a/	a/	a/	a/
600 Income Security	DL	14.1	1.5	1.8	1.9	1.5	1.5	1.3
	PG	0.0	0.0	0.0	0.0	0.0	0.0	0.0
700 Veterans' Benefits and Services	DL	1.1	1.4	1.5	1.4	1.3	1.1	1.0
	PG	12.1	12.1	16.3	16.9	17.5	18.1	15.1
TOTAL	DL	52.8	42.8	37.5	36.1	35.1	34.1	33.9
	PG	84.7	94.4	88.1	91.6	94.7	97.9	97.6

NOTES: DL = Net direct loan obligations.
PG = Primary loan guarantee commitments.

a. Less than $500 million.

APPENDIX C

FEDERAL RECEIPTS AND EXPENDITURES IN THE NATIONAL INCOME AND PRODUCT ACCOUNTS

Both the budget and the federal sector of the National Income and Product Accounts (NIPA) measure the receipts and expenditures of the federal government. The national income accounts measure current income and production and are the most widely used indicator of current economic activity. As a rule, the NIPA federal sector is more useful than the budget for analyzing the economic impact of federal government activity. The NIPA estimates of federal government activity differ from those of the budget in four ways: timing of transactions, netting and grossing of receipts against spending, treatment of financial activities, and coverage.

Timing differences occur because the budget records transactions (except interest owed to the public) on a cash-paid or cash-received basis, while the NIPA federal sector may use a cash, accrual, or other basis, depending on the type of transaction. On the receipts side, the most important timing difference is the recording of corporate profit taxes in the NIPA at the time the tax liability is incurred, which may be months (or years) before the money is deposited in the Treasury. On the expenditure side, the only major timing difference is that some large defense purchases are recorded in the NIPA at the time of delivery rather than at the time payment is made. Other timing differences are generally small.

Differences in netting and grossing arise because the budget treats certain types of receipts as offsets to outlays. For example, employing-agency payments to the Civil Service Retirement Trust Fund and other federal employee benefit plans are counted as a negative outlay in the budget, exactly offsetting agency expenditures elsewhere. In the NIPA, this amount is added to both receipts and expenditures in order to provide a more accurate measure of personal income and outlays. In the benchmark revision of the NIPA, government contributions to military retirement are treated the same as contributions for civilian employees. Other netting and grossing adjustments in the NIPA are made for funds collected by the government in the course of business-type transactions--such as veterans' insurance programs, timber sales, and rents and royalties arising from the Outer Continental Shelf leases.

Lending transactions that involve only the transfer of existing assets and liabilities are generally excluded from the NIPA federal sector, since they do not reflect current production of goods or services. For example, direct lending by the Small Business Administration is reflected in the budget but is excluded from the NIPA. Interest paid or received in the course of financial transactions, though, is reflected in the NIPA federal sector. The NIPA also records nonrecourse agricultural commodity loans as purchases of goods and services rather than loans.

Coverage differences largely reflect the exclusion of Puerto Rico, the Virgin Islands, and other territories for purposes of computing the gross national product and related data series in the NIPA.

The major differences between the budget and the federal sector in the NIPA are detailed in Table C-1. Table C-2 shows estimates of federal-sector receipts and expenditures on a NIPA basis, consistent with the CBO baseline budget projections.

TABLE C-1. RELATIONSHIP OF THE BUDGET TO THE FEDERAL SECTOR OF THE NATIONAL INCOME AND PRODUCT ACCOUNTS
(By fiscal year, in billions of dollars)

	1985 Actual	1986 Base	1987	1988	1989	1990	1991
			Receipts				
Total Revenues [a]	734	778	844	921	991	1,068	1,144
Government Contributions for Employee Retirement	32	34	35	38	41	44	48
Medicare Premiums	6	6	7	7	8	8	9
Other Netting and Grossing	9	9	10	10	10	10	11
Geographic Exclusions	-2	-2	-2	-2	-2	-2	-2
Other	-6	-2	2	2	2	1	1
Federal Sector NIPA Receipts	773	823	896	976	1,050	1,129	1,209
			Expenditures				
Total Outlays [a]	946	986	1,025	1,086	1,135	1,188	1,248
Lending and Financial Transactions	-25	-11	-13	-12	-9	-8	-7
Government Contributions for Employee Retirement	32	34	35	38	41	44	48
Medicare Premiums	6	6	7	7	8	8	9
Other Netting and Grossing	9	9	10	10	10	10	11
Defense Timing Adjustment	1	3	4	4	4	4	4
Bonuses on Outer Continental Shelf Land Leases	2	1	1	3	2	1	1
Geographic Exclusions	-5	-5	-5	-6	-6	-6	-6
Other	-3	-1	0	1	0	0	0
Federal Sector NIPA Expenditures	963	1,022	1,064	1,132	1,185	1,242	1,307

SOURCE: Congressional Budget Office.

[a] Includes on-budget and off-budget activities.

TABLE C-2. PROJECTIONS OF BASELINE REVENUES AND EXPENDITURES ON A NATIONAL INCOME AND PRODUCT ACCOUNTS BASIS
(By fiscal year, in billions of dollars)

	1985	1986	Projections				
	Actual	Base	1987	1988	1989	1990	1991
Personal Tax and Nontax Receipts	345	361	391	428	467	507	550
Corporate Profits Tax Accruals	68	86	107	116	124	128	130
Indirect Business Tax and Nontax Accruals	56	54	53	53	54	56	58
Contributions for Social Insurance	304	322	345	379	405	438	472
Total Receipts	773	823	896	976	1,050	1,129	1,209
Purchases of Goods and Services	342	366	375	394	412	434	457
Defense	256	273	288	301	316	332	349
Nondefense	87	93	87	93	96	102	108
Transfer Payments	373	390	411	441	470	502	539
Grants-in-Aid to State and Local Governments	98	102	103	108	112	117	122
Net Interest Paid	129	139	147	157	160	160	161
Subsidies less Current Surplus of Government Enterprises	21	24	27	31	31	29	28
Total Expenditures	963	1,022	1,064	1,132	1,185	1,242	1,307
Deficit	190	199	168	156	135	113	98

SOURCE: Congressional Budget Office.

APPENDIX D

HISTORICAL BUDGET DATA

The budget policies of the federal government and the role of the budget in the national economy have changed in many ways over the past 25 years. Examining historical trends in revenues, outlays, and federal debt and comparing them with projected levels provide a framework for analyzing some of these changes. Actual budget data for fiscal years 1962 through 1985, both in nominal dollars and as a percent of gross national product (GNP), are provided in Tables D-1 through D-8.

Federal revenues, outlays, deficit or surplus, and debt held by the public are shown in Tables D-1 and D-2. Revenues and outlays contain both on- and off-budget components. All federal government receipts and outlays are on-budget except those for Social Security, which appear off-budget. Social Security is excluded from the on-budget aggregates under provisions of the Balanced Budget and Emergency Deficit Control Act of 1985. The act specifies, though, that the total deficit--including Social Security--be considered in determining whether the federal government is likely to exceed the statutory deficit targets. The amount of the total deficit is also critical in establishing the federal government's borrowing requirements. Debt held by the public represents the amount borrowed by the federal government over the years, and increases each year by roughly the amount of the total deficit.

The major sources of federal revenue (including off-budget revenues) are presented in Tables D-3 and D-4. These sources are individual and corporate income taxes, social insurance taxes and contributions, excise taxes, estate and gift taxes, customs duties, and miscellaneous receipts. Social insurance taxes and contributions include employer and employee contributions for Social Security, Medicare, Railroad Retirement, unemployment insurance, and pension contributions by federal workers. Excise taxes are levied on certain products and services, such as gasoline, alcohol, and air travel. Since 1980, excise taxes have included windfall profit taxes on domestic oil producers. Miscellaneous receipts consist mainly of deposits of earning by the Federal Reserve System.

Total on- and off-budget outlays for major spending categories are shown in Tables D-5 and D-6. These categories are national defense, entitlements and other mandatory spending, nondefense discretionary spending, net interest, and offsetting receipts.

National defense and **net interest** are identical to the budget functions with the same title (budget functions 050 and 900, respectively). The historical data for national defense have been adjusted to include imputed accruals for military retirement and are consistent with the definition of national defense used in the baseline projections.

Entitlements and other mandatory spending include programs for which spending is governed by laws making all who meet certain requirements eligible to receive payments. (Additional detail on entitlement spending is found in Tables D-7 and D-8). Many entitlement programs require that recipients have incomes below a certain level. The largest such means-tested program is Medicaid. Other means-tested entitlements include Food Stamps, Aid to Families with Dependent Children, and Supplemental Security Income.

Most entitlement programs are not means-tested, Social Security and Medicare being the largest such programs. Other retirement and disability programs include federal civilian and military retirement, Railroad Retirement, payments to disabled coal miners, and several smaller programs. Unemployment compensation, another non-means-tested program, is especially large during recessions such as the one in 1981 and 1982.

Other non-means-tested entitlements include farm price supports, general revenue sharing, revolving funds such as the Federal Deposit Insurance Corporation, and a large number of smaller trust funds.

Nondefense discretionary spending consists of all programs, other than defense and entitlements, controlled through the appropriation process. Examples include most direct federal spending for energy, the administration of justice, foreign economic and military aid, space, and natural resources. Federal grants-in-aid to state and local governments for transportation, education, housing, and community development are also considered to be discretionary.

Offsetting receipts include the federal government's contribution toward employee retirement, fees and charges such as Medicare premiums, and receipts from the use of federally controlled land and offshore territory. The bulk of these receipts from the use of federal property are rents and royalties from oil, gas, and other mineral development and proceeds from timber and power sales.

TABLE D-1. REVENUES, OUTLAYS, DEFICITS, AND DEBT HELD BY THE PUBLIC, 1962-1985
(By fiscal year, in billions of dollars)

	Revenues			Outlays			Deficit (-) or Surplus	Debt Held by the Public
	On-Budget	Off-Budget	Total	On-Budget	Off-Budget	Total		
1962	87.4	12.3	99.7	93.3	13.5	106.8	-7.1	248.4
1963	92.4	14.2	106.6	96.4	15.0	111.3	-4.8	254.5
1964	96.2	16.4	112.6	102.8	15.7	118.5	-5.9	257.6
1965	100.1	16.7	116.8	101.7	16.5	118.2	-1.4	261.6
1966	111.7	19.1	130.8	114.8	19.7	134.5	-3.7	264.7
1967	124.4	24.4	148.8	137.0	20.4	157.5	-8.6	267.5
1968	128.1	24.9	153.0	155.8	22.3	178.1	-25.2	290.6
1969	157.9	29.0	186.9	158.4	25.2	183.6	3.2	279.5
1970	159.3	33.5	192.8	168.0	27.6	195.6	-2.8	284.9
1971	151.3	35.8	187.1	177.3	32.8	210.2	-23.0	304.3
1972	167.4	39.9	207.3	193.8	36.9	230.7	-23.4	323.8
1973	184.7	46.1	230.8	200.1	45.6	245.7	-14.9	343.0
1974	209.3	53.9	263.2	217.3	52.1	269.4	-6.1	346.1
1975	216.6	62.5	279.1	271.9	60.4	332.3	-53.2	396.9
1976	231.7	66.4	298.1	302.2	69.6	371.8	-73.7	480.3
1977	278.7	76.8	355.6	328.5	80.7	409.2	-53.6	551.8
1978	314.2	85.4	399.6	369.1	89.7	458.7	-59.2	610.9
1979	365.3	98.0	463.3	403.5	100.0	503.5	-40.2	644.6
1980	403.9	113.2	517.1	476.6	114.3	590.9	-73.8	715.1
1981	469.1	130.2	599.3	543.0	135.2	678.2	-78.9	794.4
1982	474.3	143.5	617.8	594.3	151.4	745.7	-127.9	929.4
1983	453.2	147.3	600.6	661.2	147.1	808.3	-207.8	1,141.8
1984	500.4	166.1	666.5	686.0	165.8	851.8	-185.3	1,312.6
1985	547.9	186.2	734.1	769.5	176.8	946.3	-212.3	1,509.9

SOURCE: Congressional Budget Office.

TABLE D-2. REVENUES, OUTLAYS, DEFICITS, AND DEBT HELD BY THE PUBLIC, 1962-1985

(By fiscal year, as a percent of GNP)

	Revenues			Outlays			Deficit (-) or Surplus	Debt Held by the Public
	On-Budget	Off-Budget	Total	On-Budget	Off-Budget	Total		
1962	15.7	2.2	17.9	16.8	2.4	19.2	-1.3	44.6
1963	15.7	2.4	18.1	16.4	2.5	18.9	-0.8	43.2
1964	15.3	2.6	17.9	16.3	2.5	18.8	-0.9	40.9
1965	14.9	2.5	17.3	15.1	2.5	17.6	-0.2	38.8
1966	15.1	2.6	17.7	15.5	2.7	18.2	-0.5	35.7
1967	15.7	3.1	18.8	17.3	2.6	19.8	-1.1	33.7
1968	15.0	2.9	17.9	18.3	2.6	20.9	-3.0	34.1
1969	17.0	3.1	20.1	17.0	2.7	19.8	0.3	30.1
1970	16.1	3.4	19.5	17.0	2.8	19.8	-0.3	28.8
1971	14.3	3.4	17.7	16.8	3.1	19.9	-2.2	28.8
1972	14.5	3.5	18.0	16.8	3.2	20.0	-2.0	28.1
1973	14.4	3.6	18.0	15.6	3.5	19.1	-1.2	26.7
1974	14.8	3.8	18.6	15.3	3.7	19.0	-0.4	24.4
1975	14.2	4.1	18.3	17.8	4.0	21.8	-3.5	26.1
1976	13.6	3.9	17.5	17.8	4.1	21.9	-4.3	28.3
1977	14.4	4.0	18.4	17.0	4.2	21.1	-2.8	28.5
1978	14.5	3.9	18.4	17.0	4.1	21.1	-2.7	28.1
1979	14.9	4.0	18.9	16.5	4.1	20.5	-1.6	26.3
1980	15.1	4.2	19.4	17.9	4.3	22.2	-2.8	26.8
1981	15.7	4.4	20.1	18.2	4.5	22.7	-2.6	26.6
1982	15.1	4.6	19.7	18.9	4.8	23.7	-4.1	29.6
1983	13.6	4.4	18.1	19.9	4.4	24.3	-6.3	34.4
1984	13.5	4.5	18.0	18.6	4.5	23.1	-5.0	35.5
1985	13.9	4.7	18.6	19.5	4.5	24.0	-5.4	38.4

SOURCE: Congressional Budget Office.

TABLE D-3. REVENUES BY MAJOR SOURCE, 1962-1985
(By fiscal year, in billions of dollars)

Fiscal Year	Individual Income Taxes	Corporate Income Taxes	Social Insurance Taxes and Contributions	Excise Taxes	Estate and Gift Taxes	Customs Duties	Miscellaneous Receipts	Total Revenues
1962	45.6	20.5	17.0	12.5	2.0	1.1	0.8	99.7
1963	47.6	21.6	19.8	13.2	2.2	1.2	1.0	106.6
1964	48.7	23.5	22.0	13.7	2.4	1.3	1.1	112.6
1965	48.8	25.5	22.2	14.6	2.7	1.4	1.6	116.8
1966	55.4	30.1	25.5	13.1	3.1	1.8	1.9	130.8
1967	61.5	34.0	32.6	13.7	3.0	1.9	2.1	148.8
1968	68.7	28.7	33.9	14.1	3.1	2.0	2.5	153.0
1969	87.2	36.7	39.0	15.2	3.5	2.3	2.9	186.9
1970	90.4	32.8	44.4	15.7	3.6	2.4	3.4	192.8
1971	86.2	26.8	47.3	16.6	3.7	2.6	3.9	187.1
1972	94.7	32.2	52.6	15.5	5.4	3.3	3.6	207.3
1973	103.2	36.2	63.1	16.3	4.9	3.2	3.9	230.8
1974	119.0	38.6	75.1	16.8	5.0	3.3	5.4	263.2
1975	122.4	40.6	84.5	16.6	4.6	3.7	6.7	279.1
1976	131.6	41.4	90.8	17.0	5.2	4.1	8.0	298.1
1977	157.6	54.9	106.5	17.5	7.3	5.2	6.5	355.6
1978	181.0	60.0	121.0	18.4	5.3	6.6	7.4	399.6
1979	217.8	65.7	138.9	18.7	5.4	7.4	9.3	463.3
1980	244.1	64.6	157.8	24.3	6.4	7.2	12.7	517.1
1981	285.9	61.1	182.7	40.8	6.8	8.1	13.8	599.3
1982	297.7	49.2	201.5	36.3	8.0	8.9	16.2	617.8
1983	288.9	37.0	209.0	35.3	6.1	8.7	15.6	600.6
1984	298.4	56.9	239.4	37.4	6.0	11.4	17.0	666.5
1985	334.5	61.3	265.2	36.0	6.4	12.1	18.5	734.1

SOURCE: Congressional Budget Office.

TABLE D-4. REVENUES BY MAJOR SOURCE, 1962-1985
(By fiscal year, as a percent of GNP)

Fiscal Year	Individual Income Taxes	Corporate Income Taxes	Social Insurance Taxes and Contributions	Excise Taxes	Estate and Gift Taxes	Customs Duties	Miscellaneous Receipts	Total Revenues
1962	8.2	3.7	3.1	2.3	0.4	0.2	0.2	17.9
1963	8.1	3.7	3.4	2.2	0.4	0.2	0.2	18.1
1964	7.7	3.7	3.5	2.2	0.4	0.2	0.2	17.9
1965	7.2	3.8	3.3	2.2	0.4	0.2	0.2	17.3
1966	7.5	4.1	3.4	1.8	0.4	0.2	0.3	17.7
1967	7.8	4.3	4.1	1.7	0.4	0.2	0.3	18.8
1968	8.1	3.4	4.0	1.7	0.4	0.2	0.3	17.9
1969	9.4	3.9	4.2	1.6	0.4	0.2	0.3	20.1
1970	9.1	3.3	4.5	1.6	0.4	0.2	0.3	19.5
1971	8.2	2.5	4.5	1.6	0.4	0.2	0.4	17.7
1972	8.2	2.8	4.6	1.3	0.5	0.3	0.3	18.0
1973	8.0	2.8	4.9	1.3	0.4	0.2	0.3	18.0
1974	8.4	2.7	5.3	1.2	0.4	0.2	0.4	18.6
1975	8.0	2.7	5.5	1.1	0.3	0.2	0.4	18.3
1976	7.7	2.4	5.3	1.0	0.3	0.2	0.5	17.5
1977	8.1	2.8	5.5	0.9	0.4	0.3	0.3	18.4
1978	8.3	2.8	5.6	0.8	0.2	0.3	0.3	18.4
1979	8.9	2.7	5.7	0.8	0.2	0.3	0.4	18.9
1980	9.1	2.4	5.9	0.9	0.2	0.3	0.5	19.4
1981	9.6	2.0	6.1	1.4	0.2	0.3	0.5	20.1
1982	9.5	1.6	6.4	1.2	0.3	0.3	0.5	19.7
1983	8.7	1.1	6.3	1.1	0.2	0.3	0.5	18.1
1984	8.1	1.5	6.5	1.0	0.2	0.3	0.5	18.0
1985	8.5	1.6	6.7	0.9	0.2	0.3	0.5	18.6

SOURCE: Congressional Budget Office.

TABLE D-5. OUTLAYS FOR MAJOR SPENDING CATEGORIES, 1962-1985
(By fiscal year, in billions of dollars)

	National Defense	Entitlements and Other Mandatory Spending	Nondefense Discretionary Spending	Net Interest	Offsetting Receipts	Total Outlays
1962	52.3	31.3	23.3	6.9	-7.0	106.8
1963	53.4	33.7	24.6	7.7	-8.1	111.3
1964	54.8	35.0	28.4	8.2	-7.8	118.5
1965	50.6	35.3	31.8	8.6	-7.8	118.2
1966	58.1	38.0	37.6	9.4	-8.4	134.5
1967	71.4	46.0	40.1	10.3	-10.2	157.5
1968	81.9	52.7	43.2	11.1	-10.8	178.1
1969	82.5	59.2	40.3	12.7	-11.1	183.6
1970	81.7	67.1	44.2	14.4	-11.7	195.6
1971	78.9	81.7	49.0	14.8	-14.2	210.2
1972	79.2	95.4	54.9	15.5	-14.2	230.7
1973	76.7	111.5	58.3	17.3	-18.1	245.7
1974	79.3	125.2	64.7	21.4	-21.3	269.4
1975	86.5	157.2	83.9	23.2	-18.5	332.3
1976	89.6	183.8	91.4	26.7	-19.8	371.8
1977	97.2	199.2	104.5	29.9	-21.6	409.2
1978	104.5	219.5	122.3	35.4	-23.0	458.7
1979	116.3	237.9	132.7	42.6	-26.1	503.5
1980	134.0	280.6	154.2	52.5	-30.4	590.9
1981	157.5	323.5	167.7	68.7	-39.3	678.2
1982	185.3	359.8	152.8	85.0	-37.1	745.7
1983	209.9	401.2	153.6	89.8	-46.2	808.3
1984	227.4	397.0	161.5	111.1	-45.3	851.8
1985	252.7	440.2	172.1	129.4	-48.1	946.3

SOURCE: Congressional Budget Office.

TABLE D-6. OUTLAYS FOR MAJOR SPENDING CATEGORIES, 1962-1985
(By fiscal year, as a percent of GNP)

	National Defense	Entitlements and Other Mandatory Spending	Nondefense Discretionary Spending	Net Interest	Offsetting Receipts	Total Outlays
1962	9.4	5.6	4.2	1.2	-1.3	19.2
1963	9.1	5.7	4.2	1.3	-1.4	18.9
1964	8.7	5.6	4.5	1.3	-1.2	18.8
1965	7.5	5.2	4.7	1.3	-1.2	17.6
1966	7.8	5.1	5.1	1.3	-1.1	18.2
1967	9.0	5.8	5.1	1.3	-1.3	19.8
1968	9.6	6.2	5.1	1.3	-1.3	20.9
1969	8.9	6.4	4.3	1.4	-1.2	19.8
1970	8.2	6.8	4.5	1.5	-1.2	19.8
1971	7.5	7.7	4.6	1.4	-1.3	19.9
1972	6.9	8.3	4.8	1.3	-1.2	20.0
1973	6.0	8.7	4.5	1.3	-1.4	19.1
1974	5.6	8.8	4.6	1.5	-1.5	19.0
1975	5.7	10.3	5.5	1.5	-1.2	21.8
1976	5.3	10.8	5.4	1.6	-1.2	21.9
1977	5.0	10.3	5.4	1.5	-1.1	21.1
1978	4.8	10.1	5.6	1.6	-1.1	21.1
1979	4.7	9.7	5.4	1.7	-1.1	20.5
1980	5.0	10.5	5.8	2.0	-1.1	22.2
1981	5.3	10.8	5.6	2.3	-1.3	22.7
1982	5.9	11.5	4.9	2.7	-1.2	23.7
1983	6.3	12.1	4.6	2.7	-1.4	24.3
1984	6.2	10.7	4.4	3.0	-1.2	23.1
1985	6.4	11.2	4.4	3.3	-1.2	24.0

SOURCE: Congressional Budget Office.

TABLE D-7. OUTLAYS FOR ENTITLEMENTS AND OTHER MANDATORY SPENDING, 1962-1985

(By fiscal year, in billions of dollars)

Fiscal Year	Medicaid	Other Means-Tested Programs	Social Security	Medicare	Other Retirement and Disability	Unemployment Compensation	Other Non-Means-Tested Programs	Total Entitlements and Other Mandatory Spending
1962	0.1	4.2	14.1	---	2.6	3.8	6.4	31.3
1963	0.2	4.6	15.5	---	2.9	3.8	6.7	33.7
1964	0.2	4.8	16.3	---	3.3	3.6	6.8	35.0
1965	0.3	5.0	17.1	---	3.6	3.0	6.4	35.3
1966	0.8	5.0	20.2	0.0	4.1	2.4	5.5	38.0
1967	1.2	5.0	21.3	3.2	4.8	2.5	7.9	46.0
1968	1.8	5.7	23.0	5.1	5.7	2.4	9.1	52.7
1969	2.3	6.4	26.5	6.3	5.2	2.6	10.0	59.2
1970	2.7	7.4	29.4	6.8	6.6	3.4	10.8	67.1
1971	3.4	10.0	34.8	7.5	8.2	6.2	11.6	81.7
1972	4.6	11.7	39.0	8.4	9.5	7.1	15.0	95.4
1973	4.6	11.5	47.9	9.0	11.5	5.4	21.7	111.5
1974	5.8	13.9	54.5	10.8	13.6	6.1	20.5	125.2
1975	6.8	18.9	63.1	14.1	16.4	13.5	24.4	157.2
1976	8.6	22.2	72.2	17.0	18.6	19.5	25.8	183.8
1977	9.9	24.0	83.2	20.7	21.2	15.3	25.0	199.2
1978	10.7	25.3	91.8	25.0	23.2	11.8	31.7	219.5
1979	12.4	27.1	101.9	28.9	27.3	10.7	29.5	237.9
1980	14.0	32.6	117.1	33.9	31.5	18.0	33.4	280.6
1981	16.8	37.8	138.0	41.3	36.6	19.7	33.4	323.5
1982	17.4	38.1	154.1	49.2	39.8	23.7	37.6	359.8
1983	19.0	40.6	168.5	55.5	42.0	31.5	44.2	401.1
1984	20.1	41.6	176.1	61.0	43.3	18.4	36.5	397.0
1985	22.7	43.7	186.5	69.8	44.0	17.5	56.0	440.2

SOURCE: Congressional Budget Office.

TABLE D-8. OUTLAYS FOR ENTITLEMENTS AND OTHER MANDATORY SPENDING, 1962-1985
(By fiscal year, as a percent of GNP)

Fiscal Year	Medicaid	Other Means-Tested Programs	Social Security	Medicare	Other Retirement and Disability	Unemployment Compensation	Other Non-Means-Tested Programs	Total Entitlements and Other Mandatory Spending
1962	0.0	0.8	2.5	---	0.5	0.7	1.1	5.6
1963	0.0	0.8	2.6	---	0.5	0.6	1.1	5.7
1964	0.0	0.8	2.6	---	0.5	0.6	1.1	5.6
1965	0.0	0.7	2.5	---	0.5	0.4	1.0	5.2
1966	0.1	0.7	2.7	0.0	0.6	0.3	0.7	5.1
1967	0.1	0.6	2.7	0.4	0.6	0.3	1.0	5.8
1968	0.2	0.7	2.7	0.6	0.7	0.3	1.1	6.2
1969	0.2	0.7	2.9	0.7	0.6	0.3	1.1	6.4
1970	0.3	0.7	3.0	0.7	0.7	0.3	1.1	6.8
1971	0.3	0.9	3.3	0.7	0.8	0.6	1.1	7.7
1972	0.4	1.0	3.4	0.7	0.8	0.6	1.3	8.3
1973	0.4	0.9	3.7	0.7	0.9	0.4	1.7	8.7
1974	0.4	1.0	3.8	0.8	1.0	0.4	1.4	8.8
1975	0.4	1.2	4.1	0.9	1.1	0.9	1.6	10.3
1976	0.5	1.3	4.2	1.0	1.1	1.1	1.5	10.8
1977	0.5	1.2	4.3	1.1	1.1	0.8	1.3	10.3
1978	0.5	1.2	4.2	1.1	1.1	0.5	1.5	10.1
1979	0.5	1.1	4.2	1.2	1.1	0.4	1.2	9.7
1980	0.5	1.2	4.4	1.3	1.2	0.7	1.3	10.5
1981	0.6	1.3	4.6	1.4	1.2	0.7	1.1	10.8
1982	0.6	1.2	4.9	1.6	1.3	0.8	1.2	11.5
1983	0.6	1.2	5.1	1.7	1.3	0.9	1.3	12.1
1984	0.5	1.1	4.8	1.6	1.2	0.5	1.0	10.7
1985	0.6	1.1	4.7	1.8	1.1	0.4	1.4	11.2

SOURCE: Congressional Budget Office.

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